

Insurance Rating Methodology

Global Master Criteria

This report replaces the previous *Insurance Rating Methodology* report dated Sept. 4, 2014. Section VI on notching was substantially updated to reflect newly revised methodology.

Related Criteria

[Treatment and Notching of Hybrids in Non-Financial Corporate and REIT Credit Analysis \(November 2014\)](#)

[Country Ceilings \(August 2014\)](#)

[Insurance-Linked Securities Methodology \(August 2014\)](#)

[Country-Specific Treatment of Recovery Ratings \(June 2013\)](#)

[Evaluating Corporate Governance \(December 2012\)](#)

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Scope of Criteria

Fitch Ratings' Global Master Criteria Report for insurance organizations is designed to set out the minimum credit factors that Fitch considers when rating insurance entities, as well as their debt issues and policyholder obligations. This report presents the broad principles that apply for all of Fitch's insurance company ratings and is supplemented by various special reports providing more detail by company specialty (published separate of this report). Some of the most common types of insurance firms encompassed by these master criteria are listed below.

- Non-life insurance (also known as property/casualty or general insurance)
- Life insurance
- Reinsurance
- Health insurance
- Title insurance
- Mortgage insurance
- Financial guaranty
- Takaful

The guidelines in the report are purposely broad in scope, recognizing that Fitch's analytical process is dynamic and that each issuer possesses unique characteristics that cannot be captured by a narrow or overly rigid approach. Not all factors in this criteria report may apply to each individual rating or rating action. Generally, if a key criteria element is not discussed in Fitch research reports or commentary (or within internal Fitch work papers) for a given issuer or rating action, this means Fitch considers that particular element to be immaterial to the rating or rating action. This tends to hold true when a rating action is tied to an event.

This scope of this report encompasses Insurer Financial Strength ratings (IFS), Issuer Default Ratings (IDR), as well as the ratings of various long-term and short-term debt obligations, including hybrid securities. It also discusses less commonly used ratings available in insurance, such as short-term IFS ratings (ST-IFS) and Recovery Ratings (RR).

In addition to discussing the key credit factors influencing the core fundamental credit analysis of insurance companies and organizations, this criteria includes sections that expand on the following common ratings elements: forward-looking elements of ratings analysis and hybrid security treatment in ratios, group ratings, and notching. This master criteria report also includes a discussion of several other criteria elements that are less frequently applicable, including ratings of start-up and runoff organizations, short-term ratings, captive insurers, and recovery analysis.

It should be noted that generally health, title, mortgage, and financial guaranty criteria more closely follow non-life than life criteria, and criteria for reinsurance companies aligns closely with that of the primary business they assume.

About This Update

This criteria report represents the fourth update of the *Insurance Rating Methodology* following a comprehensive revision in 2011. The update focuses exclusively on *Section VI* covering *Notching: Debt, Hybrid, IFS Ratings and Holding Companies*. This report replaces the previous *Insurance Rating Methodology* report dated Sept. 4, 2014. The following is a summary of key modifications:

Varied Regulatory Impact: Updated notching criteria employs a revised approach in jurisdictions migrating to Solvency 2-style group regulation, whereas notching will remain more aligned with our historical approach in jurisdictions, such as the U.S., where the insurance regulatory approach has not significantly changed.

Holding Companies: At investment grade, we typically will no longer notch down by one the IDR of the holding company relative to the IDR of the operating company in Europe or other jurisdictions operating under forms of “group solvency” regulation. We will continue to notch down the holding company in the U.S. and other jurisdictions where formulaic “ring-fencing” style restrictions remain in place.

Debt/Hybrid Recoveries: Notching for debt/hybrid ratings linked to recovery assumptions generally will be unchanged globally for operating companies and holding companies.

Hybrid Nonperformance Risk: In addition to notching for recoveries, hybrids will continue to also be notched based on risk of “Nonperformance.” We have amended our criteria to more closely align it with Fitch criteria employed for banks, including designations of Nonperformance risks as being “Minimal” (additional notching of 0–1), “Moderate” (1–2 notches) or “High” (three or more notches).

IFS Notching: We will set the IFS rating one notch above the IDR of the operating company when regulation is strong based on the view that regulators will intervene sufficiently early when problems emerge, in order to preserve assets in a stress scenario. Previously, IFS ratings were only rated above the IDR if policy or reinsurance obligations are afforded legal priority. As a technical matter, the IFS rating will be defined as the initial anchor rating for notching purposes. Previously, the IDR was defined as the initial operating company anchor.

Impact of Criteria Update on Ratings

This update is expected to result in numerous, primarily one-notch, rating changes:

- Of approximately 320 hybrid ratings, we expect approximately 25%–30% to be revised upward by one notch, 3% by two notches and 2% will be revised downward by one or two notches. Most hybrid ratings of European, Asia-Pacific, Canadian and Bermudan issuers will be revised, whereas most hybrid ratings of U.S. issuers will be unchanged.
- Of approximately 300 international scale IFS ratings, we expect 4% will be revised upward by one notch and none will be lowered. Of approximately 45 classes of operating company debt rated globally, we expect 21% to be revised downward by one notch.
- Of approximately 120 holding company IDRs, we expect 20% will be revised upward by one notch, mainly in Europe (where approximately two-thirds of holding company IDRs are expected to be revised upward). Of approximately 90 classes of holding company debt rated globally, approximately 6% will be revised upward by one notch and 5% will be revised downward by one notch.

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A. Key Credit Factors — Overview

The main factors used by Fitch in support of the core fundamental credit analysis of an insurance company or group follow below. These factors are grouped by those that are qualitative in nature, and those that are primarily quantitative. Various types of insurance ratings to which these factors apply are discussed in *Section XI-B*.

Key qualitative factors are:

- Sovereign and country-related constraints
- Industry profile and operating environment
- Market position and size/scale
- Ownership
- Corporate governance and management

Key quantitative factors are:

- Capitalization and leverage
- Debt service capabilities and financial flexibility
- Financial performance and earnings
- Investment and asset risk
- Asset/liability and liquidity management
- Reserve adequacy
- Reinsurance, risk mitigation, and catastrophe risk

Where applicable and material, Fitch may assess any non-insurance-related risks or exposures based on the appropriate Fitch rating methodology for that exposure.

In very select cases, an additional qualitative factor that can limit the rating level exists for start-up and runoff organizations. See *Section VII* for details.

The financial ratios discussed in this section are high level, and provide an overview of select key ratios applicable at a global level. These global ratios are discussed in more detail beginning on page 33. In practice, more than just these ratios are used in support of Fitch's analysis.

These credit factors are applied to the analysis of the "rating unit," which may be an individual insurance company, consolidated group, or part of a group, depending on the rating exercise. Defining the rating unit(s) is the first step in Fitch's analysis.

As part of its general assessment, Fitch may consider market-based indicators, such as credit default swap (CDS) rates, bond prices, market-implied ratings, market value of equity, and share price movements. Fitch's ratings are based exclusively on the credit fundamentals of an insurer, while these market-based indicators are used to help identify relative degrees of financial flexibility, as well as being a tool to identify changes in market information and sentiment.

B. Sovereign and Country-Related Constraints

An important step in Fitch's analysis is to assess the sovereign and country risk environment, and to judge if this places any constraints on the attainable rating.

The table below highlights how insurance ratings can relate to, and possibly be, constrained due to either a Country Ceiling or the credit profile of a sovereign. Further details are provided in the criteria documents *Country Ceilings* (August 2013), and *Country-Specific Treatment of Recovery Ratings* (June 2013) available on www.fitchratings.com.

Country Ceilings are not ratings, but instead are a key analytical input and constraint on the foreign-currency ratings of entities and obligations originating in the sovereign's jurisdiction. They are developed by Fitch's Sovereign ratings group in concert with the setting of a country's sovereign ratings.

Sovereign ratings speak to the creditworthiness of a government and its ability to meet its obligations. Sovereign ratings are typically assigned to both a government's local currency and foreign currency obligations. When governments experience financial pressures, at times this can affect the credit quality of all of the entities located in that country since such pressures often relate to economic weaknesses or systemic issues. The impact of these pressures can vary materially among entities in the country.

None of the constraints discussed in this section apply to national ratings.

Figure I-1: Sovereign and Country Ceilings Summary

Basic Constraints	Impact on Attainable Rating
Country Ceiling	FC Rating: Places cap on all FC ratings in a country to reflect Fitch's view on risk of transfer and convertibility (T&C) risks due to potential imposition of foreign exchange controls in periods of sovereign crisis. In very select cases, an entity can be rated above the Country Ceiling if it is structurally shielded from T&C risks (i.e. significant assets outside country, foreign strategic partners willing and able to support, etc.). LC Rating: Not subject to Country Ceiling since not exposed to T&C risks.
Sovereign Rating	FC and LC Ratings: Very strong entities can be rated above the applicable LC Sovereign rating if they are judged to be sufficiently strong to withstand a sovereign crisis. Insurance organizations typically will be rated no more than 1–2 notches above the LC Sovereign, but only if: a) their profile otherwise implies a higher rating than the sovereign, b) the insurer is not directly exposed to issues constraining the Sovereign rating level, and c) the insurer does not holds high levels of government debt. Fitch notes in many emerging markets, government debt can dominate insurers' portfolios, making it less likely to rate above the Sovereign in such cases. However, in select cases, Fitch would allow insurers with very strong credit profiles, coupled with sizeable international business diversification (measured at 20% or more of the net premiums from sources outside of its home country on a sustained basis), to exceed the sovereign rating by a maximum of one notch, even if the insurer had large government bond holdings. In addition, the FC and LC ratings of an insurer may also be rated above the LC Sovereign rating if it benefits from support by a strong foreign shareholder.
Other Considerations	Impact on Attainable Rating
Insurer Financial Strength (IFS) Ratings	IFS ratings are typically not specifically designated as LC or FC. It is not uncommon for policyholder obligations to be in multiple currencies. When LCs dominate, the IFS rating will be treated as a LC rating per above. When FCs are material (i.e. estimated to be consistently greater than 25% of total policy obligations^a), the IFS will be rated as a FC rating.

^aBased on nonlinked reserves for life and net premiums for non-life, as a proxy. FC – Foreign currency. LC – Local currency.

C. Industry Profile and Operating Environment

Organizations that operate in segments of the insurance industry that are viewed as higher risk may be rated lower than those operating in lower risk segments, all else equal. For example, Fitch has no title insurer rated above 'A' for IFS, but a number of life and non-life insurers, especially mutuals, are rated well above this level. This difference in part relates to the greater diversity among many life and non-life companies compared with the monoline nature of title insurance.

The table below shows a summary of how industry profile and operating environment can impact the typical ratings range for several key segments (within most developed markets not constrained by a Country Ceiling or by the Sovereign environment).

- The thicker band indicates a probable ratings range within which a majority of companies would be expected to reside.
- The thinner band extending out to the arrows reflects the full range of ratings that could theoretically be achieved.
- A smaller number of companies with more unique circumstances would fall in the ratings range represented by the area between the arrows and thicker band.

In tables, such as Figure I-2 to the right, IFS Rating Category indicates the IFS rating category of the operating insurance company and Senior Debt Rating Category indicates the senior debt rating of the insurance holding company, not the operating company.

Figure I-2: Ratings Range Based on Industry Profile/Operating Environment

IFS Rating Category	AAA	AA	A	BBB	<BBB
Senior Debt Rating Category	AA	A	BBB	BB	<BB
Non-Life	←	←	←	←	←
Reinsurance Lines	←	←	←	←	←
Composite	←	←	←	←	←
Life/Annuity	←	←	←	←	←
Accident and Health		←	←	←	←
Title Insurance			←	←	←
U.S. Managed Care			←	←	←
Takaful			←	←	←
Financial Guaranty		←	←	←	←

Most insurance ratings published by Fitch fall into the investment-grade categories due to heavy regulatory oversight plus a fundamental business need for financial strength. Thus, the tables used in this report typically present each of the investment-grade categories separately and the non-investment-grade categories as a single grouping.

Because industry risks affect a broad cross section of insurers, in Fitch's published reports and rating action commentaries on a given rated entity (and within internal Fitch committee presentations and work papers), often industry risks are not discussed in detail. Instead, industry risks are most often discussed in industrywide special reports or commentaries. Conclusions from these special reports and analyses may be considered by analysts and rating committees at the entity level.

A more detailed discussion of how industry profile and operating environment is assessed for various sectors follows.

Non-Life Insurance

Fitch believes that the key risks inherent in the non-life insurance industry are derived from:

- Cyclicalities of year-to-year results.
- Intense competition in most sectors.
- Challenges in predicting, pricing, and reserving for losses from products with long reporting and claims settlement tails.
- Exposures to large “low frequency, high severity” losses such as property catastrophes.
- Certain lines of business are highly regulated from an availability and rate perspective, making it hard to exit or adjust prices if operating results are poor.

Fitch believes factors favorable to credit fundamentals include:

- Limited competition that products face from outside of the industry, although competitive advantages are rare and commodity pricing is the norm.
- Demand for a number of products is supported by third-party requirements that individuals and companies carry certain types of insurance. For example, in a number of jurisdictions, auto third-party coverage is mandatory.

Life and Annuity Insurance

Fitch believes that the key risks inherent in the life insurance industry are derived from:

- Mortality, longevity, and morbidity experience, and from the result of investment activities including interest rate, credit, liquidity, and equity variability.
- Shifts towards asset accumulation products, typically with some investment guarantees, are increasing market-based investment risks.
- Trend of increased product complexity, which requires more sophisticated financial management and has increased regulatory and operational risk.
- Strong competitive pressures on pricing and profitability due to overcapacity and slow growth in traditional products.
- Increased competition from larger and well-established non-insurance financial institutions, such as banks and asset managers.
- High levels of regulation in most jurisdictions.

Fitch believes factors favorable to credit fundamentals include:

- Products generally have a lower underwriting risk than non-life insurance, offer limited guarantees, have a long duration and offer limited policyholder optionality.
- Changing demographics and growing concern over state-funded pension schemes are driving growth in demand for retirement income products and services.
- Tax-favored status of many products, although this varies by country and product.

Reinsurance

Companies operating in the reinsurance market face several unique challenges tied to greater distance from the underlying risk exposure, and are therefore dependent to a degree on the underwriting and claims data and expertise of the ceding company, particularly on proportional accounts.

In addition to the general risks noted for non-life and life products, industry risks particular to reinsurers include:

- Potential liquidity and/or credit availability needs derived from a requirement to often collateralize a portion of their ceding company obligations via trust accounts or bank letters of credit.

- The willingness of reinsurers' institutional client base to accept new reinsurers reduces entry barriers in the reinsurance market.
- For life reinsurers that tend to be specialized, a need to develop and maintain unique underwriting expertise as well as greater exposure to adverse selection.
- Also for life reinsurers, possible significant exposure to pandemics or other mortality catastrophes.

Favorable characteristics include:

- Less restrictive premium rate and policy form regulations compares to primary companies.
- Access to a pool of data and expertise from across their client base, which can inform their underwriting and pricing.

Title Insurance

Fitch believes that the key risks inherent in the title insurance industry are derived from:

- Exposure of the core product to the cyclical nature of real estate market activity, as well as the product's commodity nature.
- High levels of fixed costs that can create operational challenges when revenues experience cyclical declines.
- Monoline (undiversified) nature of the business, and uneven track record in attempts to diversify.
- General exposure to fraud-related activities of agents (i.e. theft of escrow funds). Such losses occur from time to time. For large insurers serving diverse populations of many agents, a single loss is typically not a material event. However, a single loss could materially affect smaller insurers or those serving a concentrated population of agents.
- Intense competition among major players.

Favorable characteristics include:

- A product that is an integral part of the real estate transaction since demand in the U.S. is driven by requirements for a title insurance policy by banks.
- Generally low investment leverage and less exposure to investment risks than other insurance sectors.
- Periodic movements by potential competitors for substitute products, while a threat, have been unsuccessful.

Accident and Health/U.S. Managed Care

Fitch believes that the key risks inherent in the health and managed care insurance industry are derived from:

- Healthcare reform legislation at the federal level in the U.S.
- Political risks (especially in the U.S.).
- Rate regulation, which can be intense and is complicated by high levels of healthcare cost inflation.
- Monoline (undiversified) nature of the business.

Favorable characteristics include:

- Barriers to entry tend to be high given significant scale advantages, which generally favor larger and established players.
- Generally low investment leverage and less exposure to investment risks than other insurance sectors.

Takaful

Fitch makes the following observations with respect to Takaful:

- Takaful is a form of financial protection, similar to insurance. But unlike conventional insurance, Takaful firms must comply with Islamic principles when carrying out takaful business.
- From a corporate governance and risk management perspective, Fitch seeks to understand the composition of, and extent of interaction between, the Shari'ah Council and the management board for an effective Takaful operation. Fitch does not approve, certify, or evaluate Shari'ah compliance.
- Investment restrictions associated with Shari'ah could have a credit impact on investment risks of takaful firms, especially in markets with limited availability of Sukuk investments and the consequent difficulty of investing in high-quality assets while avoiding investment concentrations.
- In evaluating the reinsurance risk of the Takaful firms, reinsurance counterparty risk/collectability could be a concern for those selected firms who use lowly rated re-Takaful providers to gain Shari-ah compliance.

Financial Guaranty

Fitch believes that the key risks inherent in the financial guaranty insurance industry are derived from:

- The monoline (undiversified) nature of the business.
- The high sensitivity of the business model to even modest perceived changes in financial strength.
- The industry's limited financial flexibility under financial stress.

Favorable characteristics include:

- The industry's expertise in credit underwriting and surveillance, combined with active management of troubled credits.
- Recent losses in the municipal debt market have highlighted the potential benefits of financial guarantees to bondholders.
- Generally low levels of debt and financial leverage.

D. Market Position and Size/Scale

An insurer's business mix, scale, and competitive market position within its chosen markets are important factors in considering the underlying company risk profile, as are the strategies that drive such positioning. Thus, individual insurer's profit potential and capital volatility will differ significantly based on the composition, size, and positioning of the underlying product portfolio by segment and geography. Diversification across products and geographies are typically credit positives while Fitch recognizes that even apparently diversified portfolios can become more correlated under extreme conditions.

The table below demonstrates how these features can influence the typical ratings range for non-life and life insurers (in developed markets not constrained by a Country Ceiling). These relativities are considered by evaluating companies relative to peers at the broad sector level. For example, a small regional U.S. medical malpractice insurer would be compared with U.S. property/casualty insurers overall in assessing its placement below. It would not be compared with only other medical malpractice insurers.

Figure I-3: Ratings Range Based on Market Position and Size/Scale

IFS Rating Category	AAA	AA	A	BBB	<BBB
Senior Debt Rating Category	AA	A	BBB	BB	<BB
Large Market Position and Size/Scale	←	←	←	←	←
Medium Market Position and Size/Scale		←	←	←	←
Small Market Position and Size/Scale			←	←	←

The impact of market position, size, and scale influence on the typical ratings range for other insurance sectors can be found in the applicable insurance Sector Credit Factor report at www.fitchratings.com.

While the level of competitive advantage enjoyed by an insurer is an important ratings consideration, competitive advantages can be difficult to sustain over extended periods. Product innovations can often be readily mimicked by competitors and third-party outsourcing arrangements can provide access to technological capabilities and expense efficiencies. Nevertheless, there are benefits to scale, brand strength and awareness, high service levels, market share in individual businesses, and assured access to strong distribution channel networks.

Distribution capabilities are evaluated in terms of volume, productivity, cost, and diversification. In several product lines, access to distribution serves as a barrier to entry. Fitch views distribution as having a direct impact on an insurer's growth prospects, and can indirectly affect product profitability by influencing cost, in-force persistency, and underwriting performance. Finally, an insurer's distribution channels can also have an impact on its regulatory and reputation risk in some markets.

E. Ownership

Ownership speaks to the evaluation of the impact of ownership from the perspective of the rating unit, as defined by Fitch at the beginning of the ratings exercise. Ultimately, Fitch's goal is to assess if ownership is neutral, favorable, or unfavorable to the rating.

Mutual versus Stock (Public) Ownership

Both public and mutual ownership are considered neutral to the rating, except at the 'AAA' level. While public ownership typically offers higher levels of financial flexibility and access to capital, mutual ownership offers fewer conflicts in owner and creditor interests.

Figure I-4: Ratings Range Based on Ownership Form

IFS Rating Category	AAA	AA	A	BBB	<BBB
Senior Debt Rating Category	AA	A	BBB	BB	<BB
Stock		←	→	→	→
Mutual	←	←	→	→	→

Fitch currently does not, nor does it anticipate, assigning 'AAA' IFS ratings to insurance companies other than those owned under the mutual form of ownership (and even then, only in rare cases). Fitch believes that the need to meet shareholder return hurdles, together with the marginal (if any) competitive advantages of being rated in the 'AAA' category versus the 'AA' category for IFS, imply that 'AAA' rating levels generally do not make economic sense for stock companies in the non-life sector. Mutual insurers, on the other hand, have greater incentives to hold excess capital and liquidity positions, or employ other conservative risk management measures, since returns on capital are a lower priority.

This is illustrated in the table below for life and non-life insurers in developed markets.

Private Ownership

Ownership of an insurance organization by a private firm — for example, a hedge fund or private equity firm, bank or corporate/industrial entity — can be neutral, positive or negative for the insurance ratings, depending on unique circumstance, as discussed in the table below.

Figure I-5: Private Ownership Ratings Considerations

Positive to Rating	The impact can be positive if the private owner is higher rated and would be expected to support the insurance group. This would be most likely if there were perceived synergies related to the ownership, such as in a bancassurance situation.
Negative to Rating	The impact can be negative if the parent is lower rated, and/or for whatever reason would be expected to govern the insurance group in a manner to increase risks, to remove capital or to expose the insurer(s) to non-insurance risks within the parent structure.

Supranational Ownership

Ownership of an insurer by a supranational organization, such as a development bank, can be neutral, positive or negative. Supranational ownership can be positive if the supranational is highly rated and can be expected to support the insurer (typically involving use of callable capital facilities). Additionally, insurers with supranational ownership, similar to mutual insurers, may feel less pressure to lever up in order to meet return on capital targets. Also, in some cases, an insurer owned by a supranational may be exempt from currency exchange controls by its sponsoring governments.

Conversely, supranational ownership can be a negative if the supranational manages the insurer in order to simply meet political goals of the sponsoring governments, and doing so results in a weakened stand-alone financial profile. For example, if the insurer is managed to weak capital targets and/or severely underprices its products.

See *Section V* for a discussion of sovereign ownership.

Rating Unit Defines Perspective

If Fitch's ratings evaluation encompasses a parent company's debt ratings as well as all (or most) of the subsidiary insurance company IFS ratings, the rating unit would likely be defined as the organization as a whole. In such a case, ownership would be considered based on ownership of the ultimate parent company. This could encompass public ownership, mutual (policyholder) ownership, or some form of private ownership (another company, private equity, government, etc.).

On the other hand, if the rating unit is defined as one or more insurance subsidiaries within a broader organization (insurance or non-insurance), ownership would be first evaluated based on the nature of the direct, private ownership of that insurance company. In such a case, Fitch would consider the impact of how the insurance company fits into the organization, as discussed above. If appropriate, Fitch would also consider the ultimate ownership of the immediate parent.

Distinction from Group Rating Methodology and Notching

Fitch notes that the evaluation of ownership is distinct and different from the application of Fitch's Group Rating Methodology (*Section IV*). The latter speaks to application of ratings to various operating company members of an insurance organization based on their relationship to each other. Ownership as defined in this section speaks to parentage.

The discussion of ownership here, too, is distinct from the establishment of a holding company rating relative to that of its operating company subsidiaries. Holding company notching is discussed in *Section VI-C*.

F. Corporate Governance and Management

The governance and management of an insurance organization can influence all of the other key credit factors discussed in this section and Fitch's assessment of management/governance overlaps with its assessment of a company's overall fundamental credit profile. However, there are additional, specific assessments that may be conducted by Fitch related to an organization's management and governance.

Good governance practices will not increase a rating, all other factors being equal. However, poor governance practices, including either jurisdictional or issuer-specific corporate governance issues, can result in lower ratings than typical quantitative and qualitative credit factors may otherwise imply. This is demonstrated in the table below for life and non-life insurers in developed markets. In some cases, corporate governance can be so ineffective that Fitch is not able to rate the insurer.

Fitch evaluates both jurisdictional and issuer-specific characteristics. Further details on corporate governance are discussed in Fitch's report *Evaluating Corporate Governance*, which serves as background to these criteria. Those elements of governance that would negatively affect insurance industry ratings include:

- A substantive lack of board independence or planning activities by the board.
- A management team that is viewed as ineffective, key members of management that are guilty of work-related civil or criminal offenses, or management that has blatantly ignored board risk tolerances on multiple occasions.
- Major audit-related issues, such as multiple material weaknesses in the internal control environment, no audit opinion or unfavorable opinion, financial statements are consistently late, or there is a change in the auditor due exclusively to major disagreements on material accounting treatments. Fitch tends to become aware of audit-related issues when financial statements with unfavorable opinions are published, or when issuers are unable to publish financial statements as scheduled. The ratings process does not typically predict such events.
- Related party transactions appear to be highly suspect.

Less significant weaknesses in any of the above areas could potentially constrain ratings.

Figure I-6: Ratings Range Based on Corporate Governance and Management

IFS Rating Category	AAA	AA	A	BBB	<BBB
Senior Debt Rating Category	AA	A	BBB	BB	<BB
Effective	←	←	←	←	←
Generally Effective, but Some Weakness Noted			←	←	←
Ineffective					←

In addition, Fitch would usually expect well-managed and well-governed insurance companies to have effective risk management processes. Examples of areas that analysts may take into consideration with respect of an organization's risk management are:

- Management's appetite for risk and communication through the organization.

- The independence of any risk management function as well as senior management's understanding and involvement in risk management issues.
- The perceived effectiveness of processes and, in some cases, tools to monitor and control risks relative to the organization's risk appetite.
- Whether all risks are managed centrally or can be easily compiled to establish an enterprise wide view of risk.

Fitch is not in a position to audit risk management systems, and the agency generally only comments publicly on risk management where it is viewed as a significant rating driver or outlier. In situations where management does not interact with Fitch, the evaluation is typically based on historic performance, peer comparisons, and/or market intelligence.

G. Capitalization and Leverage

Fitch's analysis of the capitalization of an insurance organization is done from several perspectives, and typically includes review of the following:

- Capital adequacy ratios (CARs), which measure the strength of regulatory capital (or similar measurements) relative to the risk exposures of the insurance operations. One example is Fitch's Prism model used for life and non-life insurers in the U.S., EMEA, and Asia.
- Financial leverage ratios (FLRs), which measure the use of debt or debt-like hybrid securities to finance both long-term capital and short-term liquidity needs. A key focus is on the financing of regulatory capital, and thus FLRs typically exclude "match funded" or operating debt.
- Total financing and commitments (TFC) ratio, which is designed to measure the total debt, financing, and capital markets footprint of an organization and its overall reliance on ongoing access to funding sources.

The form of the above ratios can vary across different insurance sectors, as well as across different countries and jurisdictions. The latter may reflect differences in regulatory reporting standards and conventions.

For example, CARs in the U.S. are typically measured at the statutory operating company level, reflecting a regulatory focus on subsidiary-level capital. In EMEA, CARs are often measured at the consolidated group level (in addition to the company level), reflecting a greater focus on group regulation. Fitch considers differences in regulation, and the incentives this places on how capital is managed, when interpreting the above ratios.

In the U.S., the regulatory focus on insurance company subsidiary capitalization has resulted in extensive use of holding company structures, and employment of traditional forms of double leverage (i.e. issuance of debt or debt-like hybrids at the holding company, with proceeds contributed as pure equity capital to the subsidiary). Fitch recognizes subsidiary-level CARs benefit from this activity, and that review of holding company FLRs is particularly important to gauge the degree of double leveraging of capital at the parent level.

In EMEA, where group regulation is more prevalent, use of holding company double leverage is less common since CARs are often measured at the consolidated group level. However, in EMEA hybrid securities are used more extensively to augment capital levels included in CAR measurements (in the U.S. hybrids play a minimal role at the subsidiary level). In such cases, Fitch views the use of hybrids as a key source of potential financial leverage.

Capital Adequacy Ratios (CAR)

Capital provides a buffer for policyholders and other creditors, enabling the company to absorb adverse deviations in experience and represents an important part of the financial strength of an insurance organization. Forms of CARs considered by Fitch as part of its ratings analysis may include:

- The agency's proprietary risk-based capital assessment tools, including components of the Prism capital model and tools used for mortgage and title insurance.
- Operating leverage ratios, such as net written premium to shareholder funds, or total liabilities to shareholder funds, which are typically not risk adjusted, except for the par-to-capital leverage ratio used for financial guarantors, which is risk adjusted.
- Regulatory capital ratios, which vary among jurisdictions.

Fitch believes each type of CAR above holds merit and weighs the implications of the various measures as deemed appropriate for a given situation.

When risk-based capital measures imply strong capital and operating leverage ratios imply weak capital, Fitch could give greater weight to either set of ratios based on its judgment. While risk-based measures are in many cases more robust, high leveraging of perceived “remote” risks, as captured by operating leverage ratios, can also result in material capital impairment if such risks were understated.

In stressed circumstances, regulatory measures can become a key consideration due to either the risk of regulatory intervention, or inclusion of the measures in various ratings triggers or covenants. In such cases, regulatory measures tend to become a more important indicator of capitalization in Fitch’s analysis.

In select cases, Fitch may also consider an insurer’s own in-house capital model, when such information is made available to Fitch. However, typically due to limitations in the robustness of the information made available, and difficulties with respect to comparisons among insurers and relative to Fitch’s guidelines, results of insurers’ internal models typically have little bearing on Fitch’s overall capital assessment.

Select median guideline CAR ratios for life and non-life are shown below.

Figure I-7: Median Capital Adequacy Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Net Premiums Written to Equity (Non-Life) (x)	0.5	1.1	1.8	2.5
Net Leverage (Non-Life) (x)	2	3.5	5	7
Operating Leverage (Life ^a) (x)	7	11	15	24
NAIC RBC (U.S., Life) (%)	450	375	270	200
MCCSR Ratio (Canada, Life) (%)	220	180	165	140
Solvency I Ratio (EU, Life) (%)	220	175	150	125
Par to Capital Leverage (Financial Guaranty) (x)				
Very Low Frequency/Low Severity	30	50	90	150
Low Frequency/Low to Medium Severity	20	30	45	70
Medium Frequency/Mixed Severity				
Without Currency Risk	7.0	10.0	15.0	20.0
With Uncapped Currency Risk	5.0	7.0	10.0	16.5
High Frequency/High Severity				
Without Currency Risk	2.5	3.5	4.5	6.0
With Uncapped Currency Risk	2.0	2.5	3.5	5.0
Very High Frequency/High Severity				
Without Currency Risk	1.5	2.0	2.5	3.5
With Uncapped Currency Risk	1.0	1.5	2.0	3.0

^aMedians not applicable if liabilities comprise significant separate account, with profit or universal life reserves.
MCCSR – Minimum continuing capital and surplus requirements.

Prism Capital Model

Fitch's Prism capital model contains risk-based components that are either stochastic-based or factor-based, depending on the domicile and line of business. Fitch believes neither a stochastic-based nor factor-based approach is necessarily superior to the other as long as the model is developed with rigor. The choice as to the approach used in each jurisdiction was dictated heavily by data availability.

- Target capital (TC) in Prism is derived from either the stochastic process or application of risk factors to exposure data. TC considers exposures resulting from both insurance products sold and investment activities, among other risks. Various TC values are established at progressive levels of conservatism and simulated/assumed stress.
- Available capital (AC) reflects the entity's or group's equity capital, subject to various analytical adjustments made by Fitch. These adjustments typically reflect the amount of capital available in a controlled run off during stressed economic and/or insurance conditions, and therefore do not give full credit for items such as value of in-force business.
- The "Prism Score" describes the highest TC level that is exceeded by AC. Prism Scores are described as Exceptionally Strong, Very Strong, Strong, Adequate, and Moderately Weak.

Fitch emphasizes that the Prism Score is only an indication of capital strength; as such, the Prism Score may be higher or lower than the overall IFS or IDR rating of the insurer due to the other Key Credit Factors described in this *Section I*.

Fitch continues to publish additional details on Prism as internal validation procedures are completed. To date, Fitch has published model definition documents for its [Prism Factor-Based Capital Model](#), its [Prism U.S. Non-Life Insurance Capital Model](#) and its [Prism Factor-Based Model used in EMEA and Asia-Pacific](#). Refer to Fitch's Web site at www.fitchratings.com for the most current status on the use of Prism in the rating process.

Model documentation also exists for Fitch's capital model used for U.S. title insurers, which can be found in the [Title Insurance \(U.S.\) Sector Credit Factors](#) (see *Appendix B*) report.

Financial Leverage Ratio (FLR)

As defined by Fitch, FLRs are designed to capture the extent long-term capital (i.e. capital that supports regulatory capital adequacy or is used to fund acquisitions) is debt financed, or financed by debt-like hybrids. The FLR also includes debt used for short to intermediate liquidity or working capital needs (most commonly at the holding company level).

The primary FLR used by Fitch is the adjusted debt-to-capital ratio, which is defined as follows:

$$\frac{\text{Debt} + \text{Debt Portion of Hybrids}}{\text{Equity Capital} + \text{Debt} + \text{Total Hybrids}}$$

The debt in both the numerator and denominator is stated at nominal value and excludes "match-funded" forms of debt (referenced by some as "operating debt"). Such debt is excluded since it does not meet the definition above of being debt that finances long-term capital or supports liquidity. The derivation of the debt portion of hybrids is discussed in *Section IV* of this report.

The exact definition of equity capital used in the FLR can vary somewhat based on the financial statements used, such as U.S. GAAP, IFRS, or some other accounting basis. When

information is available, common analytical adjustments made to equity capital are shown as follows:

Shareholders' equity (or equivalent), plus:

- Adjust value of fixed-income-related invested assets to book value (i.e. amortized cost or equivalent), where appropriate, due to book value accounting for liabilities
- Include Minority Interests only if "Debt" includes the debt of the majority owned entity(ies) giving rise to the minority interest
- Include Fund for Future Appropriations, Equalization Reserves and equivalent

Goodwill provides for an additional consideration. When goodwill is material, Fitch may calculate two versions of the FLR, one that includes 100% of goodwill as part of equity capital, and one that excludes goodwill from equity capital. Fitch may place primary emphasis on the first ratio when profit margins and fixed charge coverage ratios are strong, and the market value of equity capital (for publicly traded companies) is at or above book value. Such metrics

Figure I-8: Median Financial Leverage Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Adjusted Debt to Total Capital (%)	7	20	28	35

would indicate that goodwill balances are likely supportable. The second version of the FLR that excludes goodwill may be emphasized when these and/or other metrics indicate that the goodwill value is less supportable.

In addition to the debt-to-capital ratio, in some cases Fitch may substitute alternate FLRs. For example, in the U.S. health sector, Fitch often considers the ratio of debt to earnings before interest and taxes (EBIT) to be the most informative FLR.

As part of a sensitivity analysis, analysts and committees may consider alternate versions of the FLR. For example, analysts may remove assets of questionable value from equity capital, add all of an issuer's hybrids, or add a portion of match-funded debt to debt.

In addition to reviewing the level and trend of any FLR, Fitch may also consider the make-up of the ratio. Short-term debt and debt containing covenants or acceleration triggers are generally viewed as riskier than long-term debt without covenants. Thus the mix of debt may influence Fitch views on the relative strength of an insurer's FLRs.

Rating committees may review and give weight to those FLRs deemed most relevant to the analysis at any given time.

Median guideline ratios for the FLR are shown in the table below.

Total Financing and Commitments (TFC) Ratio

Recognizing that Fitch's FLRs are defined to be narrow in scope, looking at only a certain component of debt financing, Fitch also reviews a TFC ratio.

The TFC ratio includes:

- All forms of debt, including match-funded and operating debt, as well as debt supporting long-term capital needs and liquidity and working capital needs.
- Recourse and nonrecourse securitizations.
- LOC facilities used to provide collateral/security to third parties (which are common in reinsurance transactions) and for reasons such as reserve financings.

- Various debt-like commitments, such as financial guarantees, including the full notional value of obligations related to the sale of credit default swaps (CDS); unless the issuer is a financial guarantor. The numerator of the TFC ratio for financial guarantors excludes financial guarantees and CDS since that leverage has already been captured in the par-to-capital leverage ratio.

These various values are summed and then divided by equity capital, as defined on the preceding page.

TFC helps bridge what Fitch perceives as a blurring line between “financial debt” and “operating debt,” and also captures various off balance sheet financing exposures, such as securitizations. Examples of this blurring of the line include various reserve financing activities (securitizations, letter of credit facilities, match-funded senior debt supported), embedded value securitizations, catastrophe bonds, insurance subsidiary secured borrowings, and match-funded debt issued by holding (as opposed to operating) companies.

During periods of market disruptions, and lost access to capital markets financings, such operational and off-balance sheet commitments can become a direct source of vulnerability to an organization.

Because TFC includes a mixture of highly disparate exposure types, and because the risk of these can vary greatly, Fitch does not employ any absolute standards as to targets for TFC values at any given rating level that would be applicable to all insurers in a sector. At times, however, for a given organization, rating committees may establish maximum TFC tolerances for a given rating level.

When TFC levels for an organization are increasing, or appear high relative to peers, Fitch may assess the risks associated with the various exposures captured by TFC. This can include any of the following:

- The extent TFC financings and/or commitments are leveraged relative to capital.
- The vulnerability of the organization's inability to refinance debt and other TFC commitments.
- Calls on liquidity related to TFC commitments.
- Losses to capital that could result from TFC commitments that turn sour and the leveraging impact of such losses.

It should be noted that “total” is used as a general descriptor to imply the TFC is intended to be broad based. No ratio or set of ratios can truly capture the totality of a company's risk exposures.

H. Debt Service Capabilities and Financial Flexibility

Fixed-Charge/Interest Coverage

Interest coverage is a measure of the affordability of interest payments, and defined as EBIT/financial interest expense (excludes interest on “match-funded” debt), where EBIT is earnings before financial interest and taxes. Low levels of interest coverage can lead to lower ratings generally and/or wider notching between the operating company and holding company. Typically, EBIT is measured on an operating earnings basis, excluding realized and unrealized capital gains and losses. However, when such items are large (especially due to losses linked to true stress in the portfolio), Fitch may also look at coverage ratios including these items.

Fixed-charge coverage ratios are similar and include both interest and dividends on preferred stock or hybrid securities. For hybrids, Fitch makes no adjustments for such payments if they are deferrable, unless deferral has actually occurred.

In certain jurisdictions, alternate forms of coverage are also reviewed. For example, in the U.S., analysts may review the ratio of maximum statutory dividends that can be upstreamed to a holding company by a regulated operating company, relative to interest and/or fixed charges.

Figure I-9: Median Fixed Charge Coverage Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Fixed Charge Coverage Ratio (x)	18	12	7	3

Financial Flexibility

Defined as the ability of an insurer to generate additional funds relative to needs, an insurer with financial flexibility is more able to access capital required for growth, strategic repositioning, or for the replenishment of losses. Companies with low leverage coupled with well-balanced and diverse financing sources of varying maturities are typically most financially flexible. Backup or contingent funding can prove beneficial, especially if devoid of covenants that could restrict funding under stress.

Fitch also recognizes that under stress, financial flexibility of even historically strong companies can vanish quickly. As a result of this, the agency does not assume in its forecasts that financial flexibility will necessarily exist for companies in stressful scenarios. The table below highlights how financial flexibility can affect ratings, using life and non-life as examples.

Figure I-10: Ratings Range Based on Financial Flexibility

IFS Rating Category	AAA	AA	A	BBB	<BBB
Senior Debt Rating Category	AA	A	BBB	BB	<BB
Adequate	←				→
Some Weakness Noted		←			→
Inadequate					←

I. Financial Performance and Earnings

Financial performance affects the ability to generate capital within the organization and where favorable, can positively affect the ability to absorb adverse deviations in performance as well as promoting financial flexibility.

Fitch considers not just the level of profitability but also the quality of earnings. Earnings are considered to be high quality if they are from reliable and repeatable sources such as consistent underwriting profitability. "One-off" items such as asset sales or abnormal releases from technical reserves are viewed less favorably.

An adequate level of profitability depends on the level of risk that the organization is taking. Insurers that take on a higher degree of risk would be expected to obtain a higher level of profitability in order to compensate their capital providers. On this basis, the return expected from a low-risk auto insurer would be lower than that from a higher risk catastrophe reinsurer.

Median select financial performance ratios are shown below.

Figure I-11: Median Financial Performance Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Combined Ratio (Non-Life) (%)	80	95	103	110
Operating Ratio (Non-Life) (%)	67	82	90	97
Pretax Return on Assets (Life) (%)	1.4	1.1	0.9	0.4

Growth

The first step in the evaluation of financial performance is to look at growth trends in premiums or assets. Fitch generally views growth at rates greater than the market or peers, especially during periods of competitive pricing pressures, cautiously from a ratings perspective. In fact, excessive growth is considered by Fitch to be one of the key leading indicators of future financial difficulties for an insurance company, which can take on very high weighting in a rating when concerns are significant. Fitch is concerned by excessive growth that is organic or via acquisitions. Sharp drops in premiums or assets that can be indicative of a fastly eroded franchise are also of concern.

Measuring when growth is problematic can be challenging, and ultimately requires market-specific judgments. However, as general guidance, in most developed non-life markets, Fitch would view annual premium change greater than $\pm 5\%$ of the overall industry growth rate as cautionary, and for life companies, the agency would view as cautionary asset growth greater than $\pm 10\%$ of the overall industry growth rate.

The following are additional comments for non-life and life insurers.

Non-Life Insurers

The evaluation of underwriting profitability is the first part of the earnings evaluation review for non-life (re)insurers. Fitch's goal is to judge the overall health of the book of business and management's understanding of its risks and ability to control them.

Key areas considered include:

- Performance versus pricing margins, including impact of investment income on pricing decisions.

- Performance relative to market peers.
- Volatility of underwriting results over time.
- Expense efficiencies and impact of ceding commissions on expense ratios.

Fitch measures underwriting performance using the loss ratio, expense ratio, and combined ratio. To properly interpret these ratios, Fitch considers the company's business mix, pricing strategy, accounting practices, distribution approach, and reserving approach. Fitch examines these ratios for the company as a whole, and by product and market segment when such information is available. Fitch also looks at underwriting results on a calendar and accident year basis when such information is available.

Profits derived from investments can take the form of interest, dividends, and capital gains, and can vary as to their taxable nature. Like underwriting income, investment returns and their volatility are also correlated with the level of risk assumed.

Fitch measures overall operating profitability — underwriting and investing — by calculating the company's operating ratio, which is the combined ratio less the investment income ratio (investment income divided by premiums earned).

Life Insurers

For life insurers, Fitch looks at earnings and various measures of margin at the product line level and calculates standard profitability ratios on a consolidated basis. While strong profitability is generally viewed positively for life insurer ratings, Fitch recognizes that strong near-term profit may be the result of incremental risk taking, such as inadequate hedging, which would be negative for ratings.

Fitch also interprets profitability ratios within the context of operating and financial leverage, recognizing that high returns resulting from high leverage are a negative for ratings, and that low returns due to low leverage are actually a sign of reduced risk.

Fitch uses other quantitative measures that vary by market. For example, in select cases the return on embedded value (ROEV), new business margin, and embedded value variances are used, but only for life insurers that provide supplementary financial reporting on an "embedded value" basis. This mainly includes large life insurers in the EMEA and Asia-Pacific regions.

Wherever possible, Fitch evaluates the diversification of earnings, including the balance by market and product, between risk-based and fee-based earnings and the mix of profit from new sales versus older in-force profit to further understand the quality of earnings. In general, all else equal, earnings that are well-diversified tend to be less volatile.

In addition to profit, Fitch's review also uses growth in sales, revenue, expenses, and assets as a measure of performance. These growth trends are considered in the context of market conditions and company-specific strategic initiatives.

- Since in many markets life insurance is a mature industry, Fitch generally views modest growth in sales, consistent with market averages, as a sign of health.
- Fast growth is often a sign of aggressiveness, especially if growth is focused on new products (or new product features), and could have a negative impact on ratings.
- Sharp reductions in sales could be the sign of a weakening franchise, which could place pressure on management to take on added risks to increase sales.

Qualitative interpretations of the key drivers of growth trends are an important part of Fitch's evaluation.

J. Investment and Asset Risk

Taking investment and asset risk in a controlled fashion is typically an inherent part of the business model of any insurance company. In Fitch's assessment of asset risk for an insurer, four key areas are considered: credit risk, market risk, interest rate risk, and liquidity risk.

Fixed-income investments tend to be the largest asset class. That said, insurers bear a varying degree of credit exposure as organizations make different choices regarding the trade-off between yield and default risk, and have differing investment opportunities in their market of origin, depending, for example, on regulatory limitations. Fitch considers the mix, composition, and credit quality of an insurers' fixed-income portfolio. When appropriate, asset stress testing that estimates economic losses by asset class in more severe economic conditions is conducted to assess insurers' credit exposures.

While fixed-income investments dominate most insurer portfolios, a portfolio allocation to equity securities or real estate is not uncommon. Such investments may provide higher expected returns over time, but are also generally significantly more volatile.

- At times, Fitch stress tests equity and real estate investment values, taking into account the mitigating benefits of risk sharing (if any) with policyholders.
- The goal is to consider the potential impact on capital from severe market downturns.

Equity investment positions may include positions in derivatives, hedge funds, or private equity vehicles. Concentrations in these types of investments are viewed more cautiously, as they have greater uncertainty in terms of valuation and liquidity.

Median investment ratios are shown below.

Figure I-12: Median Investment Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Risky Assets ^a to Surplus/Equity (Non-Life) (%)	25	50	75	100
Risky Assets to Surplus/Equity (Financial Guaranty) (%)	5	10	15	20
Equities to Surplus/Equity (Life) (%)	12	27	45	60
Below Investment-Grade Bonds to Surplus/Equity (Life) (%)	20	40	55	70

^aThis ratio is a combination of the non-investment-grade bond, unaffiliated common stock and investment in affiliates to surplus/equity ratios.

In some emerging markets, insurers may invest in foreign assets, aiming to increase the diversification of their investment portfolio and/or to enhance yield. However, Fitch believes that a significant currency mismatch between assets and liabilities would substantially increase the volatility of an insurer's earnings and capital position. In such a case, subject to data and information availability, Fitch would evaluate the company's hedging strategy, including the types of instruments used (e.g. currency swaps, proxy hedging) and costs associated, and/or how hedges have performed historically.

The investment portfolio is evaluated in conjunction with the liabilities as part of a broader review of asset/liability and liquidity management, as discussed on the next page. This is a greater focus for life insurers than for most non-life companies.

Fitch also pays close attention to unusual investment strategies, especially those involving esoteric investments, less liquid investments, or use of concentrations by name or sector.

K. Asset/Liability and Liquidity Management

Asset/liability and liquidity management (ALM) is most often a significant risk factor for life insurers given the high investment leverage that is often associated with this business as well as the typical product features.

- Strong ALM is critical for life insurers that have a high exposure to liquid (surrenderable) liabilities, particularly for cash on guaranteed terms.
- For life companies with limited liquidity risk, appropriate ALM processes are still important in order to achieve profitability objectives.
- These two ALM goals — management of liquidity and management of earnings — are related but do not fully overlap.

In contrast, most non-life insurers typically generate sufficient cash flow to pay current claims, so the risk of having to liquidate investments at a disadvantageous point in time is generally low. Liquidity takes on greater importance for non-life companies in short-tail insurance sectors and in the event of large catastrophe losses, as well as at the holding company level.

For companies writing reinsurance business, Fitch may also consider how any collateralization requirements for business written may affect liquidity and financial flexibility, particularly to the extent of which such requirements are dependent on financial covenants or rating triggers.

Operating Companies

Fitch evaluates liquidity at the operating company based on the marketability of investments, as well as the amount of liquid assets relative to liabilities. The manner in which the company values its assets on the balance sheet is also closely examined. Fitch also considers the amount of receivable and other balances, as well as the impact of very nonliquid assets such as affiliated holdings or office buildings.

Median liquidity ratios are shown below.

Figure I-13: Median Liquidity Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Liquid Assets to Technical Reserves (Non-Life) (%)	200	150	125	100
Liquid Assets to Liabilities (Financial Guaranty) (%)	200	150	125	100
Liquid Assets to Policyholder Liabilities (Life) (%)	85	75	60	45

It should be noted that assessment of ALM-related risks can be particularly challenging, at times, given limited disclosures in published financial statements and notes.

For life insurers, Fitch's evaluation of ALM and liquidity risk focuses on an evaluation of the liquidity characteristics of the life insurer's assets and liabilities based on an understanding of the life insurer's ALM approach and, where available, an assessment of the company's modeling results under a range of deterministic and dynamic scenarios. Alternative sources of liquidity to fund unexpected cash needs are evaluated based on their amount and availability.

Liquidity risk is a key consideration in Fitch's analysis of life insurers. However, liquidity risks can vary significantly from market to market, depending on the local operating environment. Therefore, Fitch takes this into account, as local market-specific factors can significantly increase or mitigate liquidity risks that a life insurer is exposed to.

- Traditional ALM approaches used by life insurers include duration/convexity and cash flow “matching” of assets and liabilities, typically within some target range.
- More sophisticated approaches involving complicated hedges using derivative instruments increase exposure to operational, counterparty, and basis risk.

In cases where liquidity risk is considered to be a very material element (such as some U.S. life insurers), the liquidity characteristics of the life insurer’s assets and liabilities are evaluated to determine expected liquidity needs (to fund claim payments and surrenders) relative to liquidity sources (ability to convert assets to cash) under various stress scenarios.

In addition to evaluating scenario-testing results when available, Fitch also calculates traditional liquidity measures looking at operating cash flow and comparing liquid assets with total liabilities. Fitch may also use other quantitative measures and models to assess ALM and liquidity risk that vary by market.

Non-life (re)insurers are less likely to maintain tight duration matches between assets and liabilities relative to life counterparts that manage “spread” or nonlinked businesses. An asset duration that is longer relative to liabilities creates an exposure to a decline in economic value as interest rates increase.

- Generally, a mismatch is not a major concern for a non-life insurer with adequate cash flow, high-quality investments, and a buy and hold investment approach.
- In periods of economic stress brought on by high inflation, non-life insurers with longer duration mismatches will face greater asset and capital volatility.

For lines exposed to catastrophic loss, such as property reinsurance, Fitch reviews how an insurer would potentially generate sufficient liquidity to fund claim costs at various modeled probable maximum loss levels, when available.

Holding Companies

Analysis of liquidity at the holding company level differs from that at insurance operating companies, when holding companies essentially exist solely to own various operating subsidiaries and conduct no insurance business themselves. Typically, if liquidity problems develop in an insurance organization, they are most likely to occur at the holding company level.

Unlike operating companies, holding companies do not normally carry significant amounts of liquid assets, and are much more reliant on generation of cash flow as a key source of liquidity. Maintenance of cash balances at a conservative multiple of annual cash needs, such as debt service requirements, is generally viewed as prudent.

Refinancing of maturing debt is a key source of liquidity risk at many holding companies. Thus, Fitch may review debt maturities by year together with current short-term debt balances. Unexpected maturities or payments due to covenant triggers and/or guarantees being enacted can be particularly troublesome.

Following are the key sources and uses of cash flow that Fitch may consider in assessing holding company liquidity.

Figure I-14: Holding Company Liquidity — Sources/Uses

Sources	Uses
Earnings on Holding Company Invested Assets	Cash Operating Expenses
Regulated Dividends from Subsidiaries	Shareholder Dividends
Nonregulated Dividends from Subsidiaries	Preferred Dividends
Long-Term Debt Issuance	Interest Expense
Commercial Paper Issuance	Capital Contributions to Subsidiaries
Equity Issuance	Long-Term Debt Maturity
Bank Lines Drawn	Commercial Paper Maturity
Tapping Cash or Liquidating Investments	Share Repurchases
Other Sources	Bank Lines Due (Including Covenant Triggers)
	Pension Plan Funding
	Contingencies
	Other Uses

L. Reserve Adequacy

Loss reserve adequacy is a critical part of analyzing a non-life (re)insurer, but it is also one of the most challenging areas of analysis and one most susceptible to variability in results. A demonstrated ability to maintain an adequate reserve position is a crucial characteristic for a highly rated insurer.

The greatest challenge is that the data available to conduct the review, whether information available from statutory filings (such as Schedule P for U.S. insurers or Prudential Regulation Authority returns in the U.K.) or tables available from management as used for internal analysis, may be both limited in availability and difficult to interpret.

Fitch's review also focuses on any uses of reserve discounting, financial or finite reinsurance, or accounting techniques that reduce carried reserves, and potentially distorts comparability.

Fitch evaluates loss reserves from four perspectives:

- Profile
- Growth
- Experience
- Adequacy

Profile

In reviewing the reserve profile, Fitch judges how important reserve risk is as a credit factor in the overall rating. Reserve leverage relative to both capital and to incurred losses is a primary consideration in this assessment (see ratio definitions on page 36). Higher reserve leverage tends to be common with longer-tail writers, and implies a greater weighting of the reserve assessment in the final rating, as per the table to the right.

Figure I-15: Implied Weighting of Reserves in Rating

Loss Reserves/ Incurred Losses	Reserve Leverage		
	<1.0	1.0– 1.5	>1.5
>2.0	Medium	High	High
1.0– 2.0	Medium	Medium	High
<1.0	Low	Medium	Medium

Growth

Fitch evaluates if loss reserves are growing at a rate that is commensurate with growth in underwriting exposures. Reserve growth that falls short of growth in underwriting exposures indicates increasing degrees of caution, per the table to the right.

Figure I-16: Reserve Growth

Ratio	Neutral	Caution	High Caution
Paid/Incurred Losses	<1.05	>1.05	>1.50
Change in Ratio of Reserves/ Earned Premium (%)	>(5)	<(5)	<(15)

Fitch also considers the rate of overall growth in premiums, relative to market averages, in its evaluation of *Financial Performance and Earnings* (Section I-f).

Experience

Evaluating historic development trends in reserves provides an indication of a company's recent and historical ability and proficiency in setting reserves. Consistent favorable

development is viewed as a positive in the reserve assessment, whereas adverse development (or reserve strengthening) indicates increasing degrees of caution.

Adequacy

Finally, when information is available, Fitch will make an assessment as to the overall adequacy of current carried reserves. This assessment can be based on any combination of reviews of actuarial reports, disclosures by management of internal or independent actuarial estimates of reserving point estimates or ranges, and Fitch own analysis of loss experience data. When reserves are carried below midpoint or best estimates, this implies increasing levels of caution, whereas reserving at levels above these estimates is viewed favorably, per the table below.

Rating Implications

In most developed markets, Fitch would view rankings in the “neutral” range with respect reserve growth, experience and adequacy to imply that reserves meet an ‘A’ IFS rating category standard. Companies with several cautionary indications would be viewed at a ‘BBB’ standard or lower with respect reserves, and those with one or more high cautionary indications at a non-investment grade/nonsecure reserve standard (i.e. ‘BB’ or lower).

For a reserve indication to rise to ‘AA’ or ‘AAA’, the growth indication would need to be neutral, and the company would need to show enduring positive indications with respect both experience and adequacy indicators. ‘AAA’ level reserve adequacy is likely to be uncommon.

Figure I-17: Reserve Development

Ratio (%)	<0%	0%–5%	5%–10%	>10%
One Year Development Ratios	Neutral	Slight Caution	Caution	High Caution
Five Year Development Ratios	Positive	Slight Caution	Caution	High Caution

Figure I-18: Carried Reserves/Estimated Midpoint

Ratio	Implication
>105%	Positive
100%–105%	Neutral
90%–100%	Moderate Caution
80%–90%	Caution
<80%	High Caution

M. Reinsurance, Risk Mitigation and Catastrophe Risk

Various forms of risk protection are available to insurers, including reinsurance, risk securitization, industry loss warranties (ILWs), or capital markets products such as options, forwards, or futures. Fitch's goal is to determine if capital is adequately protected from large loss exposures and to judge if the ceding company's overall operating risks have been reduced or heightened. Certainly, tight product designs that limit risks, as well as diversification, can act as a first line of defense.

- Where reinsurance contracts are considered to reduce risk materially, this would be viewed positively for a rating.
- Over-reliance on specific forms of risk mitigation, such as quota-share reinsurance or active hedging, may be considered negative for ratings.
- Over-reliance on reinsurance can increase potential counterparty, dispute, and ongoing availability issues.

Reinsurance is used more extensively among non-life than life insurers. Fitch notes that higher rated insurers often use less reinsurance because their stronger financial standing and less-concentrated portfolio allows them to retain more of their own risk.

Given it is still the most commonly used form of risk mitigation, especially among non-life insurers, in assessing reinsurance programs, Fitch's goal is to gain comfort in that:

- Sufficient amounts and types of reinsurance are being purchased to limit net loss exposures given the unique characteristics of the book.
- Reinsurance is available when needed.
- The cost of purchasing reinsurance does not excessively drive down the ceding company's profitability to inadequate levels and weaken its competitive posture.
- The financial strength of reinsurers is strong, limiting the risk of uncollectible balances due to insolvency of the reinsurer.
- Exposure to possible collection disputes with troubled or healthy reinsurers is not excessive.

Figure I-19: Median Ceded Reinsurance Ratio Guidelines

	Insurer Financial Strength (IFS)			
	AAA	AA	A	BBB
Reinsurance Recoverables to Surplus/Equity (Non-Life and Financial Guaranty) (%)	25	45	65	100
Net Notional Par Insured to Gross Notional Par Insured (Financial Guaranty) (%)	100	85	70	60
Single Risk Par to Capital (Financial Guaranty) (%)	5	10	20	100

Data available to Fitch to assess each of the above areas can vary greatly from company to company. In some cases, Fitch receives detailed information on reinsurance programs, and in other cases information available to Fitch may be limited to amounts ceded or recovered from reinsurers and the level of receivables and ceded reserves.

Insurance companies may also sponsor risk securitizations, such as catastrophe bonds.

Compared with reinsurance, securitizations usually pose minimal to no counterparty credit risk, since they are typically fully collateralized to the limit of coverage with high-quality and liquid invested assets

However, it is not uncommon that the protection provided to the ceding company may not be complete due to basis risk, especially if the payout is linked to industry loss indexes or a defined parameter.

Insurers can also use reinsurance offensively and potentially add to risk. In such cases, Fitch examines why the reinsurance approach is being used, and stresses what would happen if the program was unwound or developed adversely. Examples of offensive uses of reinsurance include:

- Excessive cessions under quota-share treaties simply to earn ceding commissions.
- Finite risk reinsurance driven less by risk transfer and more by risk financing objectives (although finite risk transactions contain elements of both).
- Finite reinsurance can be used to improve current period earnings, smooth earnings, and effectively discount reserves thereby enhancing capital.

Fitch typically views the quality of such capital created through finite arrangements to be less than that obtained through the use of other forms of reinsurance containing higher levels of risk transfer.

For some life insurers, risk mitigation strategies other than reinsurance can play a significant role in shaping their risk profile, including:

- Use of derivative hedging to limit market risks on guarantees on variable annuity or unit-linked type products.
- In the U.S., use of various strategies to “cede” excess reserves of life insurance lines subject to Regulation XXX to provide for regulatory capital relief.
- Outside the U.S., securitization of the “embedded value” of certain product blocks, in order to enhance capital.

Fitch’s assessment of derivative hedging is similar to that done for reinsurance, but it also may consider basis risk, management strategy, and style and controls related to the hedging program, where such information is available. For some companies, review of historic performance of the hedged business is the primary part of Fitch’s assessment.

Fitch’s assessment of Regulation XXX, embedded value securitizations, and catastrophe bonds, or other alternate forms of financings, is done as part of its analysis of the total financing and commitments (TFC) ratio and the risk of its components (page 19). Risks related to such activities can vary greatly, and Fitch notes this is a fairly fast evolving area of insurer financing activity.

Both life and non-life insurers can be exposed to catastrophic risks that are low-frequency, high-severity events. Common examples of such exposures include hurricanes or earthquakes in some parts of the world as well as the risk of a pandemic for some life insurers or reinsurers.

Catastrophe Risk

Fitch’s analysis of catastrophe risk for non-life (re)insurers involves both traditional risk analysis and in some regions, a review of the output of third-party catastrophe risk models, with the ultimate goal of evaluating various large loss scenarios relative to capital.

In all regions, the starting point for Fitch’s catastrophe risk analysis is to evaluate business mix, geographic concentration, premium growth rate, and past results in order to understand the company’s overall catastrophe risk management profile. This review considers the nature of catastrophe risk on both a marketwide basis within a jurisdiction, as well as a company’s specific share of market losses.

In many but not all cases, Fitch also reviews the results generated by non-life (re)insurers' internal catastrophe models and software. Fitch reviews model results at various confidence levels, including but not limited to 100-year, 250-year, 500-year, and 1,000-year probabilities, and beyond, when possible. Fitch believes a full evaluation of the extreme ends of the "tail" is useful, in part recognizing that actual catastrophe events seem to occur at frequencies greater than implied by many models.

Finally, Fitch has licensed AIR Worldwide Corporation's (AIR) CATRADER natural catastrophe modeling tool (primarily used for the U.S.) that models catastrophe risk and, where appropriate and feasible, produces a loss distribution curve for each insurer that fits its overall risk exposure.

Modeled catastrophe results are most informative on an annual aggregate basis (both gross and net of reinsurance) as opposed to a single-event occurrence basis, thus allowing Fitch to capture the compounding effects of multiple events in a single year, as well as the impact of diversifying exposures.

- Fitch's catastrophe risk analysis uses a tail value-at-risk (T-VaR) measure rather than a probable maximum loss (PML) approach, where available.
- T-VaR is the average of all potential losses from a specific threshold through the most extreme tail event and not just a single-point PML "return period" event.

When available, this more sophisticated, model-based catastrophe risk methodology can allow for more robust and better differentiated capital requirements among insurers. However, Fitch recognizes the potential shortfalls in any model-driven analysis and also takes care not to become overly reliant on the results of any one model without also applying judgment in interpretation of the model outputs.

N. Financial Ratio Definitions

Discussed below are some of the key financial ratios used by Fitch in its financial review of insurance companies, as presented in *Section I*. These definitions are general in nature as they are discussed from a global perspective. Exact calculations can differ at the subsector or regional level. In practice, many ratios in addition to those discussed below are also reviewed.

Financial ratios are evaluated relative to peer performance, median guidelines by rating category, and expectations developed by Fitch specific to the rated entity. In many cases, there is information value in the change in ratio values over time as well as the absolute level. As such, Fitch typically looks at a time series made up of at least five years of historical data.

Capitalization and Leverage Ratios

Net Premiums Written to Surplus/Equity (Non-Life)

The ratio indicates a company's net operating leverage on current business written and measures the exposure of surplus/equity to pricing errors. Acceptable levels of net operating leverage vary by line of business, with longer tail lines and catastrophe-prone lines often requiring lower levels of net underwriting leverage due to their greater exposure to pricing errors. Since net premiums written are influenced by both volume and rate adequacy, interpretations must be made carefully since an adverse decline in rate adequacy could lead to apparent improvements in this ratio.

Net Leverage (Non-Life)

This measure indicates a company's net operating leverage on current business written, as well as liabilities from business written in current and previous years that have not yet run off. The ratio is calculated by dividing the sum of net premiums written and total insurance liabilities (gross technical provision or gross technical reserves), less any ceded reserves, by surplus/equity, and it measures the exposure of surplus/equity to both pricing and reserving errors. Acceptable levels for this ratio will generally be higher for long-tail writers and lower for short-tail writers, reflecting natural differences in the buildup of loss reserves.

Operating Leverage (Life)

Operating leverage (life) indicates the amount of liabilities (excluding separate account or unit-linked) supported by each unit of capital. This is not a risk-adjusted measure. Where ratios are high in either absolute terms or compared with peers offering similar products, this would generally be viewed negatively.

Net Par to Capital Leverage (Financial Guaranty)

Par to capital leverage is defined by net notional insured par (net par insured through traditional financial guaranty policies or sale of credit derivatives) to capital (owners' equity plus Fitch's estimate of the equity, if any, in the unearned premium reserve). The result is compared with risk-based leverage guidelines linked to the general characteristics of the insured portfolio.

Regulatory Capital Ratios (All Sectors)

Regulatory capital requirements are also reviewed in regions where they are available, including the National Association of Insurance Commissioners' (NAIC) risk-based capital ratio in the U.S., the minimum continuing capital and surplus requirements (MCCSR) in Canada, the

Solvency I ratio in Europe and various solvency margins in other regions. Although, in some regions, local regulatory capital rules can be limited in scope and result in greater emphasis on simple leverage measures discussed above.

Financial Leverage Ratio (All Sectors)

This measure considers the use of financial leverage within the total capital structure. Financial debt excludes operating debt, such as obligations issued by non-insurance finance subsidiaries and it includes solely insurance-related financial debt provisions. Special care is taken in assessing the quality of reported equity, taking into consideration the portion supported by intangible assets such as goodwill. This ratio is adjusted to account for any hybrid securities which possess both debt and equity characteristics. See pages 18–19 for additional details, as well as *Section IV*.

Total Financing and Commitment Ratio (TFC) (All Sectors)

TFC is a comprehensive measure of debt-related leverage, making use of a broad definition of debt to include essentially all financing activities, including traditional financial debt as well as both recourse and nonrecourse securitizations, letters of credit facilities with banks provided to third-party beneficiaries (largely used by alien or offshore reinsurers and match-funded debt), and debt guarantees and other financing-related commitments.

The ratio is designed to measure the debt, financing, and capital markets footprint of an organization, and its overall reliance on ongoing access to funding sources. The measure is intended to flag those companies that have an above average reliance on the capital markets for funding, which would trigger further analysis by Fitch to understand the relative risk of the company's various funding activities. Perceived high levels of risk would have a negative impact on ratings. See page 19 for additional details.

Debt Service Capabilities and Financial Flexibility Ratios

Fixed-Charge Coverage Ratios (All Sectors)

Coverage ratios can be calculated on both an operating earnings and cash flow basis to judge economic resources available to pay interest expense, including the interest portion of rent expense, and preferred dividends. Where applicable, coverage ratios are also calculated to reflect dividend restrictions from regulated entities.

Financial Performance and Earnings Ratios

Combined Ratio (Non-Life)

The combined ratio measures overall underwriting profitability and is the sum of the loss ratio and expense ratio (including any policyholder dividends). A combined ratio less than 100% indicates an underwriting profit. Typically, lower combined ratios are required for companies writing short-tail lines generating modest investment income levels, or in which the book is exposed to periodic catastrophic or other large losses that need to be priced into income over longer periods of time.

The loss ratio measures the magnitude of incurred losses (including loss adjustment expenses) for the current calendar year relative to net premiums earned. Loss and loss adjustment expenses represent the largest expense item for most non-life (re)insurers.

Variances among insurers can be due to differences in the lines of business written, the level of rate adequacy, the tail of the book, pricing strategy with respect to expense/loss ratio mix, adverse loss items (i.e. catastrophes), and development of prior years' business, and changes in relative loss reserve strength.

The expense ratio measures the level of underwriting and acquisition expenses, such as commissions, salaries, and overhead, relative to net premiums. The denominator may use earned or written premiums depending on the local accounting convention, and the nature as to how expenses are incurred to better match costs to volume. In certain accounting regimes, expenses are incurred as paid, and in others they are incurred as premiums are earned.

Variances in expense ratio among insurers can be due to differences in distribution system costs (agency, direct, underwriting manager), the nature of the book and varying needs to underwrite each risk, pricing strategy with respect to expense/loss ratio mix, level of fixed versus variable costs, cost efficiencies and productivity, profit sharing and contingent commission arrangements, and ceding commission levels.

Operating Ratio (Non-Life)

The operating ratio measures operating profitability, which is the sum of underwriting and pretax investment income, excluding realized and unrealized capital gains or losses. The ratio is the combined ratio less the ratio of investment income to net earned premiums. Due to the combining of underwriting and investment earnings, the ratio is fairly comparable across both long-tail and short-tail lines of business. Several factors can make comparisons among companies difficult, including:

- Differences in operating leverage and the amount of investment earnings derived from invested assets supporting policyholders' surplus.
- Differences in investment strategies, particularly with respect to the taxable/tax-exempt mix and allocations to lower income/higher capital gain producing investments such as common stocks.
- Strong growth in long-tail lines for which reserves and invested asset balances have not yet accumulated to levels reflective of a mature book.

Pretax Return on Assets (Life)

This ratio measures a company's pretax, post-policyholder dividend operating profitability relative to mean assets. It is accordingly less sensitive to differences in operating leverage than a return on equity ratio. A company's age and mix of in-force business affects this ratio.

Investment and Asset Risk Ratios

Risky Assets to Surplus/Equity (Non-Life)

The three ratios discussed immediately below are combined to assess the total allocation to risk asset classes.

Non-Investment-Grade Bonds to Surplus/Equity (All Sectors)

This measures the surplus/equity exposure to bonds below investment grade (rated lower than 'BBB-'), which carry above-average credit risks. In some jurisdictions, where the country ceiling is below the investment-grade level, Fitch measures the actual exposure to "stressed" investments as a substitute measure.

Unaffiliated Common Stocks to Surplus/Equity (All Sectors)

This ratio measures the surplus/equity exposure to common stock investments. Since common stocks are both subject to price volatility and are carried at market values, a high level of common stocks potentially adds an element of volatility to reported surplus/equity levels.

Investments in Affiliates to Surplus/Equity (All Sectors)

High levels of affiliated investments can reduce liquidity, expose surplus to fluctuations (if common stock), and potentially signal a “stacking” of capital within the organization.

Asset/Liability and Liquidity Management Ratios***Liquid Assets to Technical Reserves (Non-Life)***

This ratio measures the portion of a company's net policyholder reserves covered by cash and unaffiliated investment-grade bonds, stocks, and short-term invested asset balances. Higher values indicate better levels of liquidity.

Liquid Assets to Policyholder Liabilities (Life)

This compares the amount of invested assets that can be readily converted to cash with policyholder liabilities, which may be adjusted for nonsurrenderable liabilities. The ratio is evaluated both in absolute terms and period to period.

Reserve Adequacy Ratios***Net Reserve Leverage — Net Loss Reserves to Surplus/Equity***

This ratio measures reserve exposures relative to capital. Higher leverage increases the effect on capital to any favorable/unfavorable reserve development experience.

Reserve Development to Surplus/Equity (Non-Life)

This ratio measures a company's one-year loss reserve development as a percentage of prior years' surplus/equity, and indicates the extent surplus/equity was either under or overstated due to reserving errors

Reserves to Earned Premium

This ratio considers the level of loss reserves relative to underwriting exposures, for which earned premiums are a key proxy. Changes in this ratio over time are more meaningful than the current ratio level. A sharp reduction in the ratio over time can indicate that reserves are not growing consistently with underwriting exposures, perhaps signaling a negative shift in reserve adequacy.

Calendar-Year Paid Losses/Calendar-Year Incurred Losses

This ratio assesses the flow of losses to measure changes in carried reserves over time. Barring unusual changes in premium revenues or unusual loss experience from one-time items such as catastrophes, the ratio gravitates around 1.0x for insurers typically.

Reinsurance, Risk Mitigation, and Catastrophe Risk***Reinsurance Recoverables to Surplus/Equity (Non-Life)***

This measures a company's exposure to credit losses on ceded reinsurance recoverables. The ratio includes recoverables from all reinsurers. Generally, recoverables from affiliates, pools, and associations are considered to carry lower levels of risk. The ratio should also be interpreted in light of the credit quality of reinsurers, the stability of the relationship between insurer and reinsurer, historical collection patterns, and any security held in the form of letters of credit, trust accounts, or funds withheld. Acceptable levels for this ratio will generally be higher for long-tail writers and lower for short-tail writers, reflecting natural differences in the build-up of ceded loss reserves.

II. Weighting of Key Credit Factors in Final Rating

Weighting of Key Credit Factors in Final Rating

In any discussion of how various credit factors affect ratings, one logical question would be to ask how the various areas of analysis are ultimately weighed in arriving at a final rating. In practice, ratings are derived by Fitch rating committees via judgment based on a review of all relevant credit factors highlighted in all applicable criteria reports. The weighting of the credit factors in determining the rating varies by issuer and is determined by the Fitch rating committees. The key drivers of the rating are disclosed in Fitch's reports and Rating Action Commentaries.

The rating is determined after the committee considers all of the risk elements deemed material to the rating analysis. The rationale in setting the rating, including identification of key strengths and weaknesses, expectations, as well as sensitivities of the rating, are documented in a manner consistent with the rationale described in published research reports.

With that caveat, Fitch recognizes that readers are interested in better understanding the thought process that may be employed by a rating committee. Recognizing that interest, below is a discussion of how a committee may assimilate the various credit factors in establishing a rating. It must be emphasized that the discussion below is illustrative only.

Weighting of Qualitative Factors

As discussed in other parts of this methodology, the following qualitative credit factors linked to an insurer's profile can have a material impact on achievable ratings levels: sovereign and country-related constraints; industry profile and operating environment; market position and size/scale; ownership; and corporate governance and management. In very select cases, the start-up or runoff nature of the operations of a company can act as an additional qualitative credit factor (see *Section VII*).

In other sections of this report, Fitch discusses how these qualitative factors can affect the typical ratings range, or effectively cap a rating. The weighting of the various qualitative credit factors is ultimately based on judgment. While to some degree the weakest factor may receive the highest weighting, no strict "weakest link" theory is employed.

Several illustrations follow. In each case, the agency illustrates the factors discussed in *Section VII* under the header "Length of Operations."

Figure II-1: Qualitative Factor Weighting for IFS Rating

Illustration A

Factor	Characteristic	Impact on Rating
Sovereign/Country	AAA Sovereign	No constraint on rating.
Industry Profile	Non-Life	All ratings possible, natural range at A- to AA+.
Market Position	Medium	Shifts/narrows rating range to BBB to AA; most common range within A category.
Ownership	Public/stock	Neutral, but cap at AA+.
Governance	Adequate	No constraint on rating.
Length of Operations	15 years	No constraint on rating.
Weighted Conclusion		Qualitative characteristics imply range of BBB to AA, with A category most likely.

Figure II-2: Qualitative Factor Weighting for IFS Rating

Illustration B

Factor	Characteristic	Impact on Rating
Sovereign/Country	AAA Sovereign	No constraint on rating.
Industry Profile	Life	All ratings possible, natural range at A- to AA+.
Market Position	Small	Shifts/narrows rating range to A- and below; most common range within BBB category.
Ownership	Mutual	Neutral, no cap.
Governance	Adequate	No constraint on rating.
Length of Operations	10 years	No constraint on rating.
Weighted Conclusion	Qualitative characteristics imply range of A- or lower, with BBB category most likely.	

Figure II-3: Qualitative Factor Weighting for IFS Rating

Illustration C

Factor	Characteristic	Impact on Rating
Sovereign/Country	BBB- Sovereign A Country Ceiling	Maximum rating range between BBB+ and BBB-, depending on nature of country risks and exposures to government debt.
Industry Profile	Non-Life	All ratings possible, natural range at A- to AA+ (before Sovereign impact).
Market Position	Medium	Shifts/narrows rating range to BBB to AA; most common range within A category (before Sovereign impact).
Ownership	Public/stock	Neutral, but cap at AA+ (before Sovereign impact).
Governance	Adequate	No constraint on rating.
Length of Operations	15 years	No constraint on rating.
Weighted Conclusion	Qualitative characteristics imply a natural range prior to Sovereign constraints most likely in the A category, but that rating would be limited to between BBB+ and BBB- due to Sovereign constraints.	

Figure II-4: Qualitative Factor Weighting for IFS Rating

Illustration D

Factor	Characteristic	Impact on Rating
Sovereign/Country	AAA Sovereign	No constraint on rating.
Industry Profile	Reinsurance (Non-Life)	All ratings possible, natural range at A- to AA+.
Market Position	Small	Shifts/narrows rating range to A- and below; most common range within BBB category.
Ownership	Public/stock	Neutral, but cap at AA+.
Governance	Adequate	No constraint on rating.
Length of Operations	1 year	Typically caps rating at BBB+.
Weighted Conclusion	Qualitative characteristics imply range of BBB+ or lower due greatly to start-up nature and small market positions.	

Weighing of Quantitative Factors

Similar to the discussion of qualitative factors, Fitch's analysts and committees may review each of the main areas of quantitative analysis to assess the financial profile of the insurance organization. The weighing of these quantitative factors and ratios is ultimately judgmental.

To add greater perspective, below are three very simplified illustrations of how the thought process of a committee may be applied to several hypothetical cases. It should be noted that in each case only one ratio is shown for each quantitative factor. In practice numerous ratios are likely reviewed for each factor.

Figure II-5: Qualitative Factor Weighting for IFS Rating

Illustration E

Factor	Characteristic	Impact on Rating
Sovereign/Country	AAA Sovereign	No constraint on rating.
Industry Profile	Managed Care	Natural range at AA- and below; most common between A+ and BBB.
Market Position	Large	Implies higher end of above range, likely in A category with AA- possible.
Ownership	Public/stock	Neutral
Governance	Inadequate	Would typically cap at BB+.
Length of Operations	25 years	No constraint on rating.
Weighted Conclusion		Inadequate governance would likely cap rating at BB+; otherwise profile implies range of AA- to A-.

Figure II-6: Quantitative Factor Weighting for IFS Rating

Illustration F (Non-Life)

Factor	Characteristic	Impact on Rating
Capital/Leverage	Net Leverage = 5.0	A Category characteristic.
Debt Service/Flexibility	Fixed charge coverage = 4x Flexibility = Adequate	BBB Category characteristic. Neutral
Earnings	Combined Ratio =99%	Between AA and A Category characteristic.
Investments	Risky Assets to Equity = 80%	A Category characteristic.
ALM/Liquidity	Liq. Assets to Reserves = 200%	AAA Category characteristic.
Reserves	Development to Equity = 3%	BBB Category characteristic.
Reinsurance	Recoverables To Equity = 70%	A Category characteristic.
Weighted Conclusion		Implies an average Category assessment of A. Moderate weakness in fixed-charge coverage and reserve adequacy trends is offset by very strong liquidity and good earnings.

Figure II-7: Quantitative Factor Weighting for IFS Rating

Illustration G (Non-Life)

Factor	Characteristic	Impact on Rating
Capital/Leverage	Net Leverage = 12.0	Implies less than BBB Category assessment. This would be viewed as a major deviation.
Debt Service/ Flexibility	Fixed charge coverage = 8x Flexibility = Adequate	A Category characteristic. Neutral
Earnings	Combined Ratio = 101%	A Category characteristic.
Investments	Risky Assets to Equity = 72%	A Category characteristic.
ALM/Liquidity	Liq. Assets to Reserves = 160%	AA Category characteristic.
Reserves	Development to Equity = 0%	A Category characteristic.
Reinsurance	Recoverables To Equity = 60%	A Category characteristic
Weighted Conclusion		Though most factors imply an A category, the extreme weakness of the Capital/Leverage performance would likely attract extra weighting, lowering the overall assessment to the BBB (or lower) category(ies).

Figure II-8: Quantitative Factor Weighting for IFS Rating

Illustration H (Life)

Factor	Characteristic	Impact on Rating
Capital/Leverage	NAIC RBC = 425%	AAA Category characteristic.
Debt Service/ Flexibility	Fixed charge coverage = 6x Flexibility = Adequate	A Category characteristic. Neutral
Earnings	Return on Assets = 0.85%	A Category characteristic.
Investments	BIGs to Equity = 35%	AA Category characteristic.
ALM/Liquidity	Liq. Assets to Liabilities = 80%	Between AAA and AA Category characteristic.
Reinsurance	Nothing unusual	Neutral
Weighted Conclusion		The quantitative profile indicates a very strong balance sheet coupled with more moderate earnings and related coverage characteristics. Overall quantitative assessment at low end of AA category.

Weighing of Qualitative With Quantitative Factors in Final Rating

The following discussion illustrates how the qualitative elements can be combined with the financial analysis to arrive at a final rating. While for purposes of this illustration Fitch shows the order of the analysis as the qualitative assessment coming first and the financial analysis coming second, the ordering is not important and may vary in practice.

To demonstrate, the agency first further explores Illustration A, in which the main constraint was the modest market position of the insurer, implying an 'A' category based on the qualitative assessment.

- The final notch-specific rating may be established at the "+" end of the category, or even within the next highest category, if performance on the various financial ratios exceeds that for the initial implied rating category.
- On the other hand, if ratio performance is below parameters for the initial implied rating category, the notch-specific rating may be established at the "-" level in that category, or at a lower rating category.

Accordingly, if qualitative Illustration A is matched to Illustration F, in which the quantitative assessment was also the 'A' category, the final rating will almost assuredly be in the 'A' category. On the other hand, if qualitative Illustration A is matched with illustration G, in which the quantitative assessment was no higher than 'BBB' (and arguably lower than 'BBB'), the final rating would likely be 'BBB' or lower.

Consider also the combination of Illustration B, of a life insurer with a qualitative assessment of 'A-' (or lower) matched with illustration H, in which the quantitative assessment was at the lower end of the 'AA' category. In this case, the relatively strong financial assessment would moderately uplift the rating above that provided by the qualitative assessment, and it is likely the final rating would be at the middle of the 'A' category.

As noted, the weightings to arrive at the final rating are ultimately judgmental.

Extraordinary Weighing of a Credit Factor

There may be cases as well when the committee may give "extraordinary" weighting to any one credit factor. For example, assume the implied rating based on qualitative attributes is 'A', and performance on most financial ratios also falls in the 'A' category. Typically, one would expect a final rating of 'A'. However, assume in Fitch's analysis of reserve adequacy, the committee was concerned that reserves may be materially deficient, and that on a pro forma basis adjusted for estimated reserve deficiencies, capital would be negative (implying technical insolvency). In such a case, Fitch would likely rate the non-life (re)insurer non-investment grade, giving heavy weighting to that one risk element given its critical implications.

In the case of financial guarantors, the capital adequacy assessment places a "hard cap" on the IFS rating category. However, it does not floor the rating. Thus, a financial guarantor's IFS rating will not exceed the rating category implied by its capital adequacy, but may be lower than the rating category implied by its capital adequacy.

Any other such cases in which one or more credit factors receive extra-ordinary weighting in the final rating would be highlighted in Fitch's published rating rationale.

III. Forward-Looking Elements

Forward-Looking Elements

Even though the fundamental analysis discussed in *Section 1* includes review of significant amounts of historical information, Fitch strives to be forward-looking in its ratings analysis. While this is mainly achieved by analysts and committees taking a forward-looking perspective in their review of key credit factors, Fitch may also employ any of the following techniques:

- Forecasting.
- Sensitivity analysis.
- Stress testing.

The extent of use of any of these techniques may differ greatly from company to company, or rating action to rating action, based on the perceived usefulness of the technique at a given time.

The following is a discussion of each technique.

Forecasting

Forecasting involves defining specific predictions of future performance of the issuer. Forecasting can be detailed and formal, and involve development of a set of forecasted financial statements and related ratios, or it can be less detailed or formal and involve development of general expectations in a key ratio or metric based on analyst judgment of trends.

An example of the type of forecasting most typically used in insurance ratings analysis would be development of an expectation that a key capital or leverage ratio will not fall outside of a given range.

Forecasting-related analysis may also involve review and interpretation of management forecasts or guidance.

Currently, formal forecasting of a detailed set of financial statements or cash flows is not customarily done in support of insurance ratings, but may be for a given case if an analyst or committee deemed it useful.

Fitch's forecasts and expectations of likely future events, whether formal or less formally developed, can play a key role in setting ratings levels and performance expectations.

- Typically, base case expectations, which would be considered known and measurable, are included in ratings.
- In contrast, more extreme stress scenarios, especially those that are highly unlikely or immeasurable, are not captured in ratings. However, these may be discussed in research reports as part of sensitivity analysis, as discussed below.
- At times, stress-testing results (discussed below) or other downside scenarios act as a form of forecasting. If deemed appropriate, these can be factored into ratings.

Sensitivity Analysis

Sensitivity analysis involves identification of how changes in key assumptions embedded in a rating related to key aspects of the insurer's profile could potentially result in a future ratings change. Generally, the focus is on aspects of the profile that may evolve or change over the ratings horizon, which is typically viewed as up to five years.

Priority is placed on identification of risk elements leading to assumption changes that could result in a sudden mult notch downgrade risk or upgrade potential. For example, if a company

is within reasonable proximity to triggering a covenant that could create a material liquidity call, this could be identified as an area of sensitivity for the rating.

Sensitivity analysis also considers the potential drivers of more modest one-notch or two-notch rating changes over time.

Fitch's goal is to identify sensitivities that have particular importance and relevance for the noted rating. Accordingly, extreme "macro" events such as the impact of a war are typically not identified as part of the sensitivity analysis.

However, large theoretical macro events such as losses from property catastrophes could be part of the sensitivity analysis of catastrophe reinsurers or property-oriented non-life insurers, since managing such risks are core to their business profiles.

The results of Fitch's sensitivity analysis are typically discussed in published reports via commentary.

Stress Testing

In the context of Fitch's insurance industry ratings, Fitch may conduct specific stress tests designed to identify the near- to intermediate-term vulnerability of an insurer to specific economic circumstances or events. Examples of stress tests would include investment losses from declining equity markets, the impact of sovereign strain on issuers in that country, or potential exposure to reserve deficiencies as the insurance cycle troughs. Stress tests are also known as downside scenarios.

While sensitivity analysis is typically done on a regular ongoing basis, stress testing is done on more of an ad hoc or "as needed" basis. For example, if stock markets are expected to experience unusual volatility for a given period of time, Fitch may define and conduct a stress test that considers a market decline of a given percentage of an index value.

Accordingly, stress testing tends to take place at the beginning of, and during, a period of perceived economic variability.

Stress testing is often accomplished in the insurance industry by conducting pro forma analysis on capital ratios, liquidity, and/or earnings measurements based on a defined stress event or events.

In some situations, especially when Fitch is concerned that the adverse scenario defined by the stress test may occur, Fitch may take rating actions based on pro forma stress results. In other situations, stress testing is done for informational purposes and would then be a form of sensitivity analysis.

Through the Cycle

In discussing the forward-looking elements of Fitch's ratings analysis, it is important to put this in context of an overarching aspiration that ratings generally should not change due to normal or minor cyclical variations. This is commonly referred to as rating "through the cycle."

Simply put, Fitch's aspiration is that via the various techniques discussed above, Fitch is able to form reasonable forward-looking expectations for an issuer's future performance that at any point in time would be reasonably reflected in the current rating.

It would only then be performance outside of these expectations that would result in a ratings change.

For example, Fitch may conclude that in a given market segment, a combined ratio for a non-life insurer may normally fluctuate between 92% and 105% from peak to trough in an underwriting cycle. Thus, if the combined ratio deteriorated in a year from 100% to 104% as the cycle worsened, this would not be expected to result in a rating change. However, if the combined ratio jumped to 115%, a downgrade may be considered.

Directional Ratings Indicators

Fitch uses Rating Outlook and Rating Watch designations as a means to formally communicate its forward-looking views on a rating. Details can be found at www.fitchratings.com. A brief summary of each follows.

Rating Outlook

The Rating Outlook is designed to communicate the likely direction of future ratings changes over the next 12–24 months. Outlooks reflect financial or other trends that have not yet reached the level that would trigger a rating action, but may do so if such trends continue. Outlooks are typically designated as Stable, Positive, or Negative. Occasionally, where the fundamental trend has strong conflicting elements that are both positive and negative, the Rating Outlook may be described as Evolving.

Rating Watch

A Rating Watch is typically event-driven and, as such, it is generally resolved over a relatively short period. The event driving the Watch may be either anticipated or have already occurred, but in both cases, the exact rating implications remain undetermined. The Rating Watch period is typically used to gather further information and/or subject the information to further analysis.

Additionally, a Rating Watch may be used when the rating implications are already clear, but where a triggering event (e.g. shareholder or regulatory approval) exists. The Rating Watch may extend to cover the period until the triggering event is resolved or its outcome is predictable with a high enough degree of certainty to permit resolution of the Rating Watch.

The Rating Watch is described as Positive, Negative or Evolving.

For additional information on forwarding-looking aspects of Fitch ratings, see the reports *Defining Rating Scenarios — Base and Downside Scenarios* and *Addressing Extreme Events — Ratings Reactive to Unforeseeable Events* at www.fitchratings.com.

IV. Hybrid Securities: Treatment in Ratios/Equity Credit

Hybrids: Treatment in Ratios/Equity Credit

In this section, Fitch discusses its general principles governing its treatment of hybrid securities within the various capital and leverage ratios discussed in the preceding *Section I-G*. Occasionally, Fitch may publish special reports that highlight how the application of these principles affects the treatment of specific hybrid securities, especially newer hybrids. Rating committees retain flexibility in application of these principles to specific situations not contemplated in this report.

Core Principles

Fitch believes hybrids replicate certain features of common equity only to the extent that they contribute to the ongoing viability of an organization. For insurance organizations, failure is typically brought about via an inability of an insurer to maintain adequate regulatory capital levels during periods of stress, in which losses erode capital. Hybrids aid viability to the extent they absorb or help offset losses.

Fitch employs two approaches in its treatment of hybrids:

- Hybrids are first evaluated based on Fitch's own view of how the features of the hybrid support viability.
- In the context of capital adequacy ratios (CAR, pages 16–17) only, Fitch also reviews the regulatory treatment afforded the hybrid. Fitch believes regulatory treatment has a significant impact on viability under stress, since favorable treatment of a hybrid can effectively make it loss absorbing from the perspective of the regulatory capital adequacy ratios and/or solvency margins. Generally, Fitch allows regulatory treatment to override the agency's own treatment in Fitch's CARs when the two differ.

Fitch does not apply this regulatory override in its treatment of hybrids in financial leverage ratios (FLR, page 18) or the total financing and commitments (TFC, page 19) ratio. These ratios are generally not subject to regulatory oversight (or least not to the degree or visibility of CARs), thus regulatory treatment of hybrids for these ratios has minimal impact on an organization's perceived or actual viability.

The full value of hybrids is always included as being debt-like in the TFC ratio given its previously stated definition to be an "all encompassing" measurement of an insurance organization's capital markets and financing-related footprint.

Generally, Fitch believes complexity can make it difficult to judge how a hybrid may perform. Such features that Fitch views as adding excessive complexity to a hybrid include look-back provisions, parity security language, coupon step-ups, questionable deferral features, covenants, and cross-default provisions, among others. In general, if such features are added to a hybrid and create any material uncertainties for Fitch as to how a hybrid may perform during a period of stress, those features negate favorable treatment.

Fitch's Own View on Hybrids

Fitch employs three categories in its adjustments to ratios for hybrids: 100%, 50% and 0%.

For purposes of CARs such as Prism, these percentages indicate the level of equity credit afforded the hybrid (i.e. the proportion of the hybrid that is added to available capital or AC).

In FLRs, the percentages show the portion of the hybrid that is added to debt in the numerator of the ratio. For example, in the debt-to-capital ratio, the percentage tells the portion of the

hybrid that is included in the numerator of the ratio (the entire value of the hybrid is included in the denominator).

Perpetual Preferred Securities

Perpetual preferred securities (or equivalent forms of deeply subordinated debt that have all of the features of perpetual preferred, including permanence and having deferrable coupons/interest that is noncumulative) may be treated as 100% equity in CARs, and may not be included as debt in FLRs.

As an exception, to the extent such securities are cumulative, they may be treated as 50% debt in FLRs, while still 100% as equity in the CAR. Fitch views the security's deep subordination and perpetual nature as supportive to balance sheet loss absorption, and Fitch reflects this in the CAR. However, the ultimate need to service the cumulative coupon/interest payments adds a debt-like element that Fitch has decided to reflect in the FLR.

Questionable deferral features may also negate favorable treatment in the CAR and FLR.

Dated Deferrable Debt Hybrid Securities

These encompass various deferrable subordinated debt and junior subordinated debt securities and trust preferred securities. Like debt, such securities have a stated maturity (though often long dated) but they also have dividend or interest deferral features at the option of the issuer and/or include a defined trigger that typically run to a defined maximum of three to five years.

For insurance organizations, Fitch views such securities as debt-like and providing only minimal cash flow flexibility even if deferral is made. They also carry so-called "signaling risks," meaning management's (or a defined trigger's) initiation of a deferral is seen as a signal to the market that it believes its firm is under stress. Signaling risks provide strong incentives for management to avoid deferral, whether optional or mandatory per a trigger.

Accordingly, such securities generally receive no equity credit in a CAR and 100% debt treatment in a FLR.

Mandatory Convertible Securities

Mandatory convertible securities come in two forms:

- "True" convertibles in which a single security is issued that converts to equity.
- "Synthetic" convertibles in which an underlying debt security is combined with a forward contract to sell equity in the future.

The latter typically employs a timing difference between the maturity of the debt instrument and the equity issuance, with the debt maturity extending beyond the equity issuance.

True mandatory convertible securities that are subordinated and deferrable (or zero coupon), not excessively dilutive on conversion (per exchange price/ratio), and will convert in less than three years, may be treated as 100% equity in CARs and 0% debt in FLRs. When similar securities have longer conversion periods of three to five years, they receive 50% equity credit and 50% debt treatment. If the security is senior with a conversion period of less than one year, these securities also receive 50% treatment in both ratios. Securities with less conservative features than those described may not receive equity credit in the CAR and may be 100% debt in the FLR.

Synthetic units are treated as two separate securities in ratio analysis. Thus, the underlying debt security is treated as 100% debt in FLRs from the time of issuance until it is repaid/refinanced. It receives 0% equity credit in the CAR. At the time it is issued, the equity resulting from exercise of the forward contract is treated as 100% equity in the CAR, and added to nondebt capital in the FLR (as applicable, for example, in the denominator of a debt-to-capital ratio). Prior to issuance of the equity, the forward contract is excluded from both the CAR and FLR.

To the extent forecasts or stress tests are employed, synthetic units may be modeled to perform as expected under stress.

Optional Convertible Securities

These do not receive any equity credit in the CAR and are treated as 100% debt in the FLR.

Contingent Convertible Securities

These reflect a new form of hybrid that permanently write down or convert to common equity as certain defined triggers are breached as stress sets in. They are often referred to as “CoCos” in the capital markets. A number of such instruments have been issued, mainly by banks, but also by some insurers.

Where triggers are high, meaning they would be written down or converted at early signs of stress, Fitch may treat as 50% equity in CARs and 50% debt in FLRs. When the trigger is less likely to be enacted until stress is severe, equity credit in the CAR may be 0%, and 100% of the hybrid may be added to debt in the FLR.

For any of the convertible securities, exceptions may exist, when ignoring the conversion feature, if the underlying security would qualify for favorable hybrid treatment.

A summary of Fitch's own hybrid treatment can be found in the table below.

Figure IV-1: Fitch's Own Hybrid Treatment in the Insurance Industry

Hybrid Type	CAR Treatment	FLR Treatment
Perpetual Preferred		
Noncumulative	100% Equity	0% Debt
Cumulative	100% Equity	50% Debt
Dated Deferrable Debt Securities	0% Equity	100% Debt
Mandatory Convertible (True)^a		
Sub Under Three Years	100% Equity	0% Debt
Sub Three to Five Years	50% Equity	50% Debt
Senior Under One Year	50% Equity	50% Debt
Mandatory Convertible (Synthetic)		
Underlying Debt ^a	0% Equity	100% Debt
Forward Contract	0% Equity at Issuance	0% Debt
	100% Equity Upon Funding	0% Debt
Optional Convertible^a	0% Equity	100% Debt
Contingent Convertible^a		
High Trigger	50% Equity	50% Debt
Low Trigger	0% Equity	100% Debt

^aAs an exception, favorable treatment will be used if underlying security would otherwise qualify.

CAR – Capital adequacy ratio. FLR – Financial leverage ratio.

Note: This is an illustrative summary only based on typical or anticipated hybrid features. See the criteria for further details. In all cases, favorable treatment can be negated due to complexity.

Source: Fitch Ratings.

Regulatory Override in CAR

As noted, when a rigorous regulatory regime is in place that Fitch views as supporting perceived and actual viability of an insurance organization under stress, Fitch may allow regulatory treatment of hybrids to override its own treatment in Fitch's CARs, such as Prism. This regulatory override applies both when a regulator has a more favorable treatment than Fitch's own view, and when a regulator has a less favorable treatment. The regulatory override does not apply to FLRs or the TFC.

The following defines the nature of the override in countries migrating to Solvency 2, Switzerland, the U.S., Australia, Canada, Japan and Singapore. The application of the regulatory override in other countries may be discussed in issuer-specific research reports and ratings commentary when hybrid treatment is material to the rating outcome of such issuers.

Fitch notes that based on differing local regulatory treatment, application of its regulatory override may result in similar hybrids receiving different levels of equity credit across issuers in different countries. Fitch views this as an acceptable outcome on the view that different regulatory treatment, in and of itself, can affect viability under stress.

Countries Adopting Solvency 2

For countries adopting Solvency 2, Fitch may take a prospective approach and base its regulatory override on planned Solvency 2 definitions of capital, as opposed to the various local Solvency 1 definitions currently employed in the various countries. Fitch believes this may allow for a smoother transition to Solvency 2 in the context of its criteria and make its ratings more prospective.

Fitch may define its override to include both Tier 1 and Tier 2 hybrids. Hybrids included in Tier 3 may be considered consistent with Fitch's own treatment discussed in the prior section.

While Fitch generally does not employ grandfathering in its methodologies to the extent regulators explicitly grandfather any older hybrids for Tier 1 or 2 treatment (that may not otherwise qualify) as Solvency 2 is adopted, Fitch may employ its regulatory override for these securities.

Switzerland

A similar override to that discussed above may be used in Switzerland, given the similarities of its capital methodology and that under Solvency 2. Fitch may include both upper and lower supplementary capital as defined by the Swiss regulator as AC in its CAR.

United States

Fitch may include any hybrid that is approved by a regulator to be included as "policyholders' surplus" in an insurance company's statutory financial statements as AC in its CAR. The most common example of this would be a surplus note, which generally would not qualify for AC inclusion in Fitch's treatment, but it is included as statutory policyholders' surplus.

Australia

Fitch may include any hybrid that falls within Tier 1 and Tier 2 resource definitions as established by the Australian Prudential Regulation Authority (APRA), in the context of establishing capital adequacy requirements under the risk-based capital framework, as AC in its CAR. Moreover, to the extent that APRA allows older hybrids to be "grandfathered" and treated as Tier 1 or Tier 2 capital, Fitch may employ its regulatory override for these securities.

Canada

Fitch may include any hybrid that falls within Tier 1 definitions as established by the Office of the Superintendent of Financial Institutions (OSFI), in the context of the Minimum Continuing Capital and Surplus Requirements (MCCSR) as AC in its CAR.

Japan

Fitch may include any hybrid that is approved by the Financial Services Agency (FSA) to be included in regulatory capital as AC in its CAR. The most common example of this would be “kikin” issued by mutual insurance companies.

Singapore

Fitch may include any hybrid that falls within Tier 1 resource definitions as established by the Monetary Authority of Singapore (MAS), in the context of establishing capital adequacy requirements under the risk-based capital framework as AC in its CAR.

Limits on Amount of Hybrids in Capital Structure

For insurance organizations, Fitch may not employ an absolute cap on the maximum amount of hybrids that reside in a capital structure. However, when hybrids begin to exceed 20% of total capitalization (i.e. the ratio of hybrids divided by the sum of hybrids plus debt plus equity), rating committees may consider if the debt-like features of the hybrid may be placing stress on the organization's cash flows or financial flexibility. If the committee has concerns, favorable hybrid treatment may be negated or reduced in such cases. This applies to both CARs and FLRs.

- V. Group Rating Methodology**
 - A. Key Concepts**
 - B. Willingness to Provide Support**
 - C. Ability to Provide Support**
 - D. Referral of Financial Strength**
 - E. Changes in Strategic Category**
 - F. Referral of Weakness**
 - G. Rating Above the Group Assessment**
 - H. Support in Emerging Markets**
 - I. Summary of Steps in Applying Group Rating Criteria**

A. Group Rating Methodology — Key Concepts

Group rating methodology is applied only among operating companies within a family of insurance companies. Holding company (see *Section VI-C*) and non-insurance company ratings are addressed separately.

Fitch may ultimately take one of three approaches to determine the actual IFS rating and/or IDR of a given insurance company that is a member of a group:

Stand-Alone Approach: Group member is rated strictly on the basis of its own financial profile, with no impact on its rating from its group affiliations. In this case, the stand-alone assessment becomes the IFS/IDR rating.

Partial Attribution Approach: Group member is rated reflecting some attribution of the strengths or weaknesses of other group members. In this case, the IFS/IDR ratings typically fall between the group assessment and stand-alone assessment.

Group Approach: Group member's IFS/IDR ratings are set at the same level as the group assessment.

Fitch's decision to use other than a stand-alone approach when rating members of a group is a function of two broad concepts, each with two main components:

- Willingness to provide support:
 - o Strategic importance of affiliates.
 - o Support agreements between group members.
- Ability to provide support:
 - o Financial strength of the organization and how it may limit the ability to provide support when under pressure.
 - o External barriers that restrict movement of capital/resources between affiliates.

Ultimately, when rating the insurance companies in a group, Fitch typically establishes an opinion based on the consolidated profile of all insurance affiliates, and in some but not all cases, forms an opinion on the stand-alone financial strength of various group members. Fitch's decision to develop a stand-alone assessment, or not, for a given company may be based on whether Fitch believes one is useful in the context of application of this criteria. See section Referral of Financial Strength on page 60 or additional details.

These group and stand-alone assessments are developed by Fitch only for use in application of these criteria, and may or may not be published.

For simplicity, all examples discussed in the remainder of this section will reference only the IFS rating (though they would apply to the IDR as well).

B. Willingness to Provide Support

Willingness to support group members is a function of two factors:

- Strategic importance of affiliates.
- Support agreements between group members.

In general, the more strategically important group members are to each other, the more likely Fitch is to use a group approach or partial attribution approach. The same holds true if formal support agreements are in place.

Fitch notes that its evaluation of support willingness is highly judgmental and among the most challenging decisions for a third-party observer. While an insurance affiliate may meet all of the attributes to be considered a “Core” subsidiary (as defined below), the market reality is that any affiliate or business line can be divested at any time. As a result, Fitch may reconsider the strategic category of an affiliate over time, or as events warrant.

Strategic Importance

For internal evaluation purposes, Fitch assigns one of four broad categories of strategic importance to each insurance affiliate:

- Core
- Very Important
- Important
- Limited Importance

When deemed useful to aid transparency in describing its rating rationale, Fitch may publish these categorizations in company research reports. Fitch notes that its evaluations of strategic importance may differ, at times materially, from management indications of strategic importance. Fitch makes such evaluations only in the context for use in these rating criteria, whereas management indications serve various other purposes, which may or may not be relevant to these criteria.

Core

Core includes insurers that are a key and integral part of the group's business. Core affiliates may demonstrate:

- A history of success in supporting group objectives, and the outlook for future success is at least on par with that of other Core companies.
- There are typically synergies or complements between Core companies.
- Core insurers are usually material in size relative to the whole of the organization and/or in absolute terms.

The disposal of a Core insurer will materially alter the operating profile of the organization, and will cause one to question if the organization's franchise as a whole was being significantly changed. The sale or placement into run off of a Core affiliate will almost always cause Fitch to re-evaluate its group assessment.

It should be noted that some organizations may have two or more distinct Core businesses. A common example of this would be a U.S. insurance organization composed of significant life and non-life operations with minimal integration. Fitch would typically develop a unique group assessment for each of the Core business groups.

Very Important

Very Important consists of insurers with:

- A long-term outlook for future success that have a synergistic relationship to the Core members, but fall short by a small margin, possibly due to size or newness.
- A Very Important entity could reach Core status with modest growth or some seasoning.
- The disposal of a Very Important insurer may cause one to question the strategic direction of the organization.

The sale or placement into run off of a Very Important affiliate may cause Fitch to re-evaluate its group assessment.

Important

The Important category includes:

- Insurers with a long-term outlook for future success and that have some synergistic relationship to the Core members, but do not fit being Core or Very Important.
- Important insurers typically have a lower level of synergies with the Core businesses, lackluster financial performance, small relative size, or newness to the organization.
- While a Very Important insurer falls short of Core status by a small margin, an Important insurer falls short by a significant margin.
- An Important business could be disposed of with less concern as to the effect on the overall franchise.
- Important members are often managed with the intent to grow and eventually become a Core operation.

The sale or placement into run off of an Important affiliate may or may not cause Fitch to re-evaluate its group assessment.

Limited Importance

All other members of a group may be designated by Fitch as having Limited Importance from a strategic perspective.

- While potentially strong performers, they typically have no synergistic relationship to the group other than (possibly) providing diversification to the earnings stream.
- The disposition/run off of a Limited Importance insurer will not alter the operating profile of the organization nor cause one to question the overall franchise.

In addition, an operation that is likely to be sold is typically considered of Limited Importance.

Evaluating Strategic Importance — Common Questions

In coming to its conclusions, the types of questions Fitch will consider include the following. Fitch does not necessarily review all of these questions in all cases, but will instead focus on those that it believes are most important to a given situation.

Materiality

- Does the insurer materially affect the group's profile?
- How long has the insurer been part of the group?
- Is the insurer material in size in relative or absolute terms?
- Would the disposal of the insurer lessen the franchise of the group or impair the realization of the group's strategy?
- Are there sound operating or regulatory reasons for the group to operate through a separate insurer?

Performance

- Does the insurer have a track record of supporting group objectives (such as profitability, growth, diversity)?
- What are the insurer's prospects compared with other group affiliates?

Branding

Does the insurer carry the group's name or that of a key product or trademark?

Management and Resources

- Does the insurer share board members or senior management with the parent company or other group members?
- Does the insurer share office space, back-office functions, accounting, information technology (IT), or other systems with other group members?
- Can the operations of the insurer be easily severed from the organization?
- Is the insurer wholly owned or is there a significant minority interest that could restrict the ability of the majority owner to support?

Reinsurance

- Are there reinsurance agreements in place between the insurer and other group members?
- What is the nature of these agreements, and what do they imply as to support?

Location

- Is the insurer incorporated in the same regulatory jurisdiction as other group members?

Past Support

- Does the group have a track record of giving support, capital, and/or operational, to the insurer? To other affiliates?

Support Agreement Types

Support agreements can have a material impact on the evaluation of group support in some cases, especially when group members are less than Core from a strategic perspective. Fitch may evaluate any support agreements in place among the group members to judge if they are formal or informal in the context of this criteria.

- Formal support agreements may, in many cases, result in an uplift in a group member's IFS rating.
- Informal support agreements, while informational, typically have no impact on a rating conclusion.

The following are the primary types of support agreements Fitch has observed.

Formal Support Agreements

Liability Guarantee: A formal support agreement that assures the payment in full of a group member's liabilities, as guaranteed by another group member or members. Liability guarantees are typically irrevocable and cannot be terminated for liabilities incurred during the guarantee period, even if the insurer is divested (though the guarantee can be terminated for new liabilities at any time). This is the strongest form of support agreement due to its irrevocable nature.

"Fortune-Sharing" Reinsurance: Represents the use of quota-share or certain broad-based stop-loss agreements among affiliates that are clearly structured to allow the financial fortunes of the participating affiliates to rise and fall together. A common example is reinsurance pooling arrangements, though other forms of reinsurance would also apply. In order for reinsurance to be viewed as a formal type of support, it must be written in the context of an affiliated relationship. Note, if the form of reinsurance provided can be easily provided on similar terms by an unrelated third party, and/or does not allow for fortune sharing, the reinsurance may not be viewed as a form of support for purposes of these criteria.

Capital Support Agreement: A formal support agreement signed by the board or an empowered member of executive management to maintain capital of a group member above a minimum threshold (usually defined in either absolute terms or as a percentage of regulatory required capital). In some cases, there are absolute caps on the amount of capital that will be added; in others, the commitment is unlimited. Certain capital support agreements are legally binding while in force, but they are usually revocable and can be withdrawn if the insurer is divested.

Informal Support Agreements

Management Comfort Letter: A written statement by management as to which businesses it considers Core, Very Important, or Important. Management "comfort letters" add some value by defining management's intent and by potentially providing a stronger moral obligation on the part of management to back up its statements. However, comfort letters are not enforceable. Despite being written, comfort letters are viewed as an informal form of support.

Strategic Statement: A statement by management as to which businesses it considers Core, Very Important, or Important that may include verbal commitments as to minimum capital targets for individual insurance companies. Strategic statements are not enforceable and can change if circumstances change. For instance, a new management team typically conducts a strategic review of all operations and may determine an operation that was considered key by previous management is now a candidate for disposition.

C. Ability to Provide Support

Ability to support group members is a function of two factors:

- Financial strength of the organization and how it may limit the ability to provide support when under pressure.
- External barriers that restrict movement of capital/resources between affiliates.

Level of Financial Strength

The ability of individual insurance companies to obtain regulatory approval for movement of capital and other assets between affiliated companies is seldom an issue when financial performance is good and credit fundamentals are strong. However, when credit fundamentals are weak or declining, insurance regulators are more cautious in granting their approval. In addition, other constituents such as rating agencies, creditors, distributors, and customers may take a negative view of capital movements that diverge from their expectations. Therefore, management will be under much greater scrutiny and this may limit the ability to freely move capital and resources.

- Use of a group or partial attribution approach for lower rated organizations potentially includes constraints on ratings uplift.
- Exceptions exist when formal support agreements are in place.
- Fitch often defines this threshold as having an IFS rating of 'A-' or higher.
- See section, Referral of Financial Strength, for additional details on application of such constraints for lower rated groups.

In practice, in some cases Fitch may vary the appropriate point of delineation to be higher or lower than 'A-' to reflect unique circumstances. For example, in highly ratings-sensitive businesses, a higher rating standard may be used. Alternatively, a lower standard may be used in developing markets if ratings generally are constrained below 'A-' due to a sovereign/country ceiling or if regulatory restrictions on capital flows are low and the members of the group otherwise appear able to provide support to each other.

External Barriers

Even when financial strength is high, Fitch is reluctant to take a group approach or even a partial attribution approach if it has concerns that substantial external barriers exist, as external barriers could restrict group members from supporting each other, even if they are willing.

- These barriers include regulatory or legal restrictions, potential government intervention, adverse tax consequences, and debt covenants.
- In many jurisdictions, each insurance company is regulated at the individual company level.

In almost all jurisdictions, regulatory capital ratios, and/or solvency margin requirements place some restriction on upstream dividend payments and other capital movements. Further, in some jurisdictions, insurers are free to move capital and/or invest capital within certain described formulas. However, insurers may need specific approval for any extraordinary capital movements that fall outside of the formula constraints. Regulators often make extraordinary payment approval decisions based on an analysis at the individual company level. In addition, as well as in jurisdictions that do not employ formula constraints, regulators may disallow ordinary dividend payments or other capital movements based on individual company financial trends.

The degree of regulation, and thus the degree of external barriers to support, can vary greatly based on jurisdiction.

With the growth of large international insurance players, increased cooperation among governments and the emergence of global capital markets, Fitch notes that a trend emerged throughout the 2000s, in which many of the external barriers to capital movement across countries was diminishing. This was particularly true in the developed European economies. However, Fitch notes that the financial crisis of 2008–2009 has apparently caused some local regulators to become seemingly more reluctant to give up authority to a supranational regulator, or other local regulators. In addition, domestic political considerations may constrain management's ability to support a foreign subsidiary. This may slow some of the trends of reducing barriers to support among members of global groups.

In emerging market economies, external barriers imposed by governments can become quite pronounced during times of stress. Several historical examples of sovereign stress and government interference provide insight into the ability of foreign affiliates to support local subsidiaries.

The Argentinean crisis in 2001 resulted in a massive default of sovereign securities held by insurance companies, while the asymmetrical devaluation of dollar-based assets and liabilities created a significant mismatch between the value of the reserves and the investment portfolio. During this period, foreign shareholders could not inject the required funds to keep of payment claims current due to a deposit freeze that affected the local banking system. Subsequent to these events, several international insurance groups exited Argentina.

A less drastic case can be seen in Venezuela in 2005, where the government intervened in the financial sector specifically and the private sector generally, through an array of price controls and legal requirements.

These adverse actions could prevent international insurance groups from providing support to local subsidiaries.

D. Referral of Financial Strength

Fitch may employ the general guidelines below in coming to its decision to refer strength among entities in a group for rating purposes. The typical order of the up to seven-step process in developing a final rating, by applying the overall methodology in the report, is as follows:

1. Development of group assessment.
2. Assessment of strategic category for each group member (willingness).
3. Identification and assessment of any formal support agreements (willingness).
4. Consider any barriers to support based on financial strength of group (ability).
5. Review, if any, material external barriers to support exist (ability).
6. Development of stand-alone assessments for group members, if deemed useful.
7. Apply appropriate judgment related to all of the above factors, together with benchmarks detailed below, to set final ratings.

As a final step, if applicable, Fitch may adjust company IFS ratings for any differences in recovery assumptions per *Sections VI* and *IX*.

The following is additional commentary on Fitch's process. A tabular presentation of these same concepts can be found on pages 69–70.

Stand-Alone Assessments

Per step 6 above, a stand-alone assessment may be developed per these criteria when deemed useful by Fitch. A stand-alone assessment for a given group member may be deemed useful if the strategic categorization is less than Core per step 2. A stand-alone assessment may also be deemed useful if concerns exist related to the ability of the group to provide support per steps 4 or 5, unless the risk is structurally mitigated via formal support per step 3. In most other cases, stand-alone assessments may not be deemed useful, and thus typically not developed. This latter situation tends to be true in a vast majority of cases for rated insurers.

At times, due to information constraints, Fitch may only be able to approximate the stand-alone assessment, for example, by identifying the rating category as opposed to a notch-specific opinion. If this is deemed to be sufficient by Fitch in the context of the broader methodology, Fitch may proceed in assessing the group member. In select cases, Fitch may not be able to develop a stand-alone assessment at either the notch-specific or category level (for example, due to informational constraints or a group member not possessing a true independent financial profile). If a stand-alone assessment is deemed both useful and material to the outcome, but one cannot be developed, Fitch may not rate that company. Fitch would expect this to be quite rare.

Benchmarking Guidelines

The following are additional comments on application of Fitch's criteria for the four strategic categories. In the case of all four strategic categories below, one overriding consideration is that if external barriers per step 5 indicate capital is not fungible in a strict sense, a stand-alone approach (i.e. actual rating equal to the stand-alone assessment) may be used unless a formal support agreement per step 3 mitigates the risk. In the discussion below, references to constraints due to external barriers reflects the case in which Fitch has concluded potential external barriers exist that may affect fungibility, but lack of fungibility is by no means certain. The guidelines below help frame judgments Fitch may make as to how this perceived risk should affect ratings uplift.

Core

Primary Nature of Referral: Fitch may assign the group assessment to the IFS ratings of Core members of a group, as identified in step 2.

Additional Considerations: If concerns related to the ability to support are identified in steps 4 or 5, Fitch may potentially limit full application of the group assessment. The decision may consider the number of notches between the stand-alone assessment and the group assessment per the table to the above right.

Figure V-1: Core: IFS Rating Caps

(Linked to Financial Strength or External Barriers)

Group Assessment Superior to Stand-Alone Assessment	Cap Based On Notching Up from Stand-Alone Assessment
0–2	No Cap
3–5 Notches	3 Above
6+ Notches	4 Above

Very Important

Primary Nature of Referral: Very Important insurers identified in step 2 can be rated at the level of the group assessment, or between the group assessment and stand-alone assessment, based on judgment. Certain maximum rating benchmarks are used, and limitation on the ability of the group to provide support can further affect the degree of ratings uplift.

Additional Considerations: Fitch may initially benchmark the IFS rating of a Very Important insurer first by notching down from the group assessment. The degree of notching down is based on judgment, but is constrained by the distance between the group assessment and the stand-alone assessment (unless a formal support agreement exists per step 3), with the typical highest rating level relative to the group assessment as follows in the table to the right.

Figure V-2: Very Important: Initial IFS

Group Assessment Superior to Stand-Alone Assessment ^a	Highest IFS Rating Relative to Group Assessment
0–2	Group Rating
3–5 Notches	1 Below
6+ Notches	3 Below

^aIf a formal support agreement exists per step 3, the highest IFS rating is the group rating, regardless of the distance between the group assessment and stand-alone assessment. IFS – Insurer financial strength.

Figure V-3: Very Important: IFS Rating Caps

(Linked to Financial Strength or External Barriers)

Group Assessment Superior to Stand-Alone Assessment ^a	Cap Based on Notching Up from Stand-Alone Assessment
0–2	No Cap
3–5 Notches	2 Above
6+ Notches	3 Above

^aIf a formal support agreement exists per step 3, the highest IFS rating is the group rating, regardless of the distance between the group assessment and stand-alone assessment. IFS – Insurer financial strength.

Additionally, as is done with Core insurers, if the ability to support is potentially constrained per steps 4 or 5, Fitch may also cap the IFS rating from that implied from the initial benchmark above, as follows in the lower table to the right.

Important

Primary Nature of Referral: Similar to Very Important insurers, Important insurers identified in step 2 can be rated at the level of the group assessment, or between the group assessment and the stand-alone assessment, based on judgment and subject to various constraints. All else equal, Important insurers' ratings may be lower relative to the group assessment than will ratings of Very Important insurers.

Additional Considerations: As done for Very Important Insurers, Fitch may initially benchmark the IFS rating of an Important insurer by notching down from the group assessment. The degree of notching down is based on judgment, but is constrained by the distance between the group assessment and stand-alone assessment, unless a formal support agreement exists per step 3, with the typical highest rating level relative to the group assessment as follows in the top right table.

Additionally, as is done with Very Important and Core insurers, if the ability to support is potentially constrained per steps 4 or 5, the IFS rating may be capped as follows in the lower table on the right.

Limited Importance

Nature of Referral: Limited Importance insurers identified in step 2 may be rated on a stand-alone approach at the level of the stand-alone assessment unless a formal support agreement is in place per step 3.

Additional Considerations: When a Formal support agreement is in place, a group member designated as Limited Importance can potentially have its IFS rating uplifted as high as the level of the group assessment, though the extent of any uplift may be judgmental. Fitch also typically places some caps on the degree of uplift, as follows in the table below.

Figure V-4: Important: Initial IFS Benchmark

Group Assessment Superior to Stand-Alone Assessment ^a	Highest IFS Rating Relative to Group Assessment
0-2	Group Rating
3-5 Notches	2 Below
6+ Notches	4 Below

^aIf a formal support agreement exists per step 3, the highest IFS rating is the group rating, regardless of the distance between the group assessment and stand alone assessment. IFS – Insurer financial strength.

Figure V-5: Important: IFS Rating Caps

(Linked to Financial Strength or External Barriers)

Group Assessment Superior to Stand-Alone Assessment ^a	Cap Based on Notching Up From Stand-Alone Assessment
0-2	No Cap
3-5 Notches	1 Above
6+ Notches	2 Above

^aIf a formal support agreement exists per step 3, the highest IFS rating is the group rating, regardless of the distance between the group assessment and stand alone assessment. IFS – Insurer financial strength.

Figure V-6: Limited Importance: Highest IFS Uplift due to Formal Support

Group Assessment Superior to Stand-Alone Assessment	Level of Group Assessment	
	No Financial Strength-Related Barriers: Notch Down from Group Assessment	Financial Strength-Related Barriers: Notch Up from Stand-Alone Assessment
0-2	Group Assessment	Group Assessment
3-5 Notches	1 Below	2 Above
6+ Notches	2 Below	3 Above

The Case of Multiple Core Businesses

The concepts above for the Very Important, Important, and Limited Importance categories not only apply to cases in which Fitch assigns IFS ratings to various members of a group, but they also apply when Fitch has identified several core businesses within a group, and assigns each core business a unique group assessment.

- The relative degree of linkage between the group assessments may be influenced by the same general principles as discussed above.
- If two core businesses are Very Important relative to each other, the two group assessments may more closely align than if the two are of Limited Importance.

Since cases of multiple core businesses tend to be present with larger, more complex organizations, Fitch has not developed standard notching guidelines as to how to set the two group assessments relative to each other. Instead, in such cases, Fitch uses judgment based on the general principles discussed throughout this report, and considers these relative to the unique aspects of the organization in question.

The Case of Minority Interests

If a material minority shareholder exists for a given group member (i.e. 20% or greater), Fitch may be less likely to apply as full of a rating uplift as would be otherwise implied under these criteria. Fitch's concern is that the existence of minority interests can affect fungibility of capital and other resources.

On the other hand, the existence of minority interests may also make Fitch more likely to rate a given group member above the group assessment if its stand-alone assessment is naturally higher than the group assessment. The existence of the minority interest would similarly make it more difficult to extract capital from the higher rated group member.

Fitch may employ judgment in application of these criteria in cases of material minority interests.

E. Changes in Strategic Category

Based on changes in circumstance, Fitch may at times change the strategic category assigned to a given entity. The change in strategic category in many cases may trigger a re-evaluation of the entity's rating as per the guidelines discussed in the previous section of this report. In some cases, such as a change in strategic category from Core to Limited Importance, the potential change in an entity's rating could be significant (i.e. multiple notches, if not multiple categories).

Below, Fitch discusses how ratings migration may occur when a change in strategic category is potentially indicated.

Trend

If a change in strategic category is based on emerging trends causing Fitch to question if strategic importance is increasing/decreasing, Fitch could change the Rating Outlook for a given entity, and that new Outlook could differ from the Outlook for the group more broadly.

For example, if a Core group has a Stable Rating Outlook, but Fitch is becoming uncomfortable with a particular Core entity that may be growing less strategic, Fitch could change the Rating Outlook on only that entity to Negative to flag the potential change in rating associated with its lessening strategic importance.

The opposite could be true of an insurer not fully uplifted to the Core group assessment, but whose strategic importance appears to be on the rise.

In such a case, once Fitch concluded a change in strategic category was warranted, ratings would be changed if otherwise indicated.

Divestiture — Buyer Identified

Another example that could prompt a change in strategic categorization would be an actual, pending, or possible divestiture. The nature of the ratings migration could vary greatly from case to case under such circumstances. In all cases, Fitch assumes that the divestiture will be of an entity whose actual IFS rating is higher than its stand-alone assessment due to the benefits of assumed group support.

If a group announces that it has reached an agreement to sell a previously supported entity, and the buyer is identified, Fitch may place the entity's rating on Rating Watch until the sale is complete.

Upon close of the transaction, the entity's rating may ultimately migrate to its stand-alone assessment, the group assessment of the buyer or somewhere in between, based on the ability and willingness of the new buyer to provide support (as per application of this criteria).

If for whatever reason Fitch does not and/or cannot rate the new buyer, or determine its willingness or ability to provide support, Fitch may withdraw the rating of the entity, at its pre-existing level, upon close of the transaction.

The directional indicator of the Rating Watch (i.e. Positive, Negative) will reflect Fitch's best estimate as to the likely direction in the rating, or the Rating Watch may be Evolving if Fitch cannot yet assess the likely direction. In such cases, if Fitch has developed a stand-alone assessment, and Fitch believes publishing it would be informational, Fitch may do so in its commentary supporting the Rating Watch.

Divestiture — No Buyer Identified

If the group announces that a previously supported entity is for sale but no buyer is yet identified, or that management is exploring strategic alternatives with respect the entity, Fitch may consider this as well.

While the action taken by Fitch may vary from case to case based on unique circumstances, such an announcement would typically cause Fitch to change its strategic category of the entity to as low as Limited Importance, and initiate a downgrade (if indicated by this criteria) upon the announcement.

The rationale in such a case is that the announcement by management, in and of itself, would indicate that a change in strategic importance has already occurred.

Further, without a buyer identified, the future financial strength of the entity is now unknown, which reflects a risk element to be reflected in the current rating.

In such a situation, management may indicate that it will only sell the company to a similarly rated new parent, and that if ultimately not sold, the company will be supported consistent with the prior degree of strategic importance. Such statements would typically be designed to suggest that the entity's financial strength may be maintained at its current supported level, despite the noted announcement. Such management representations may or may not affect Fitch's rating decisions based on Fitch's judgment.

Once a buyer is identified, the process described in the earlier paragraphs would be used, including use of any appropriate Rating Watch designation until the sale is completed.

Placement in Run Off

The decision of a group to exit a business by placing a group member(s) in run off would also likely prompt a change in strategic category (to Limited Importance). The rating impact of such a situation may be addressed judgmentally on a case by case basis, and any ongoing linkage of the group member's rating to the group assessment may consider how the run off is managed, the stand-alone assessment based on the runoff profile, and any formal support agreement that may be put in place. Any management representation as to ongoing support to the runoff entity, such as to preserve the group's overall reputation in the broader market, may or may not affect Fitch's rating decisions based on Fitch's judgment.

See *Section VII* for additional details on ratings of runoff companies.

F. Referral of Weaknesses

Although the primary focus of this report centers on the principles for referring strengths from one affiliate to another, Fitch also considers the case of a weak affiliate pulling down the ratings of others in its group. Though an ailing affiliate may be neither Core, Very Important, or Important, most groups will avoid “walking away” from a problem affiliate due to the negative perceptions it could bring to its franchise.

In other words, management will often feel a moral obligation to ensure that an underperforming affiliate's obligations are met, and will provide it with capital and other forms of financial support until a permanent solution is reached (usually through divestiture). Thus, even though no formal or informal support agreements may be in place, Fitch always considers the potential for implied support from stronger to weaker affiliates, even if such support would only be in place temporarily.

In these cases, Fitch may consider the amount of support that may be provided and its likelihood.

Fitch may then assess the negative impact to the insurers that would provide the support through capital contributions, additional borrowings, reinsurance agreements, absorption of expenses, or other means.

If the impact of these potential actions is material, Fitch may judgmentally adjust the ratings of the insurers potentially providing the support downward, and adjust the ratings of those receiving it upward.

G. Rating Above the Group Assessment

While rare, it is possible for a wholly owned group member to be rated higher than the group assessment under a narrow set of circumstances. Fitch's general hesitation to rate above the group assessment (other than in the previously discussed case of minority interests), is based on concerns that if a group came under financial stress, it may seek to extract capital or other resources from the higher rated group member to help assure the group's financial position.

For Fitch to consider a rating above the group assessment under these criteria, all of the following would need to be in place:

Stand-Alone Assessment Is Naturally Above the Group Assessment: The group member possesses its own independent operational and financial infrastructure and its business is generally unrelated to that of the group as a whole.

Strong Strategic Rationale to Be Rated Higher than Group Assessment: Typically, this would be present in a highly ratings-sensitive business in which the group member could not compete with a rating at the level of the group assessment. In such cases, there is logical incentive for management to manage the group member such that its financial resource will not be fungible to the other parts of the group. Fitch generally would not view the goal of attainment of a higher rating in a less ratings-sensitive business as sufficient rationale for purposes of the criteria (i.e. an auto insurer seeking an 'AA' rating versus the group assessment of 'A+').

Material Adverse Consequences for Group from Breaching Segregation: Stated another way, the adverse economic impact to the group resulting from a downgrade of the group member (resulting from extraction of financial resources) should far outweigh any economic benefit derived from extracting the financial resources. This should be true both in the expected case, and under plausible stress cases. Fitch believes this is the most important aspect of these criteria, and also the most difficult for management to demonstrate.

Reliance on the Group as a Whole for Financing Is Very Limited: An example may include capital contributions to support growth. The more reliant the group member is on the performance of the lower rated group, the less likely it is that Fitch would rate the group member higher than the group assessment. A demonstrated ability of the group member to grow capital organically at a rate consistent with revenue or premium growth is helpful in meeting this guideline.

While there are no theoretical limits on the notching between the group assessment and stand-alone assessment, it would be extremely rare for the group member to be rated more than one to three notches above the group assessment. The degree of notching is judgmental.

If provided to Fitch, the agency may review any structural protections management has put in place that may limit the ability of the group to extract capital and other financial resources from the group member. However, under this criteria report, these are simply considered informational, and would not affect the degree of notching or Fitch's decision to rate above the group assessment. Fitch recognizes that under extreme stress conditions, it is likely that most structural protections could be reversed (since the group controls the wholly owned group member's board of directors), making them of little value when most needed.

H. Support in Emerging Markets

The participation of international insurance groups in emerging markets presents special challenges when applying a group rating methodology. Despite the important position these groups may hold in developing countries, the ratings of emerging market subsidiaries must consider several risk elements. These include issues related to:

- Relatively small size within the overall group.
- Often small size within the local market.
- The relative importance of growth in emerging markets to overall group strategy.
- The possibility that legal issues or government intervention may limit the ability or willingness for group support.

Historic examples of sovereign stress and government interference in Argentina and Venezuela highlight the challenges of referring group strength in emerging markets. Considering these issues and the limitations regarding size, strategic importance, and geographical isolation, most of the local operations of international insurers would not be considered Core. Similarly, Very Important and Important insurers would be found less frequently than those in developed markets. Limitations regarding the enforcement of any agreement of support, even if deemed formal, could also limit the rating uplift.

Assigning international ratings to entities domiciled in countries with a low sovereign rating could result in additional limitations for the group rating methodology, given constraints placed on ratings via the country ceiling (for more information, see the criteria report "Country Ceilings" at www.fitchratings.com). Regardless of the strength of the support, it is highly unlikely that a local subsidiary could attain the group assessment.

The Case of Sovereign-Owned Entities

As with other parent/subsidiary relationships, principles underpinning these criteria can apply in cases when an insurance organization is a sovereign-owned entity (SOE). While in a majority of cases, Fitch would not view sovereign ownership as strategic, and thus rate the SOE under the stand-alone approach, in some cases sovereign ownership could warrant referral of strength.

Such referral of a sovereign's strength in the rating of the SOE would likely be most pronounced in developing markets in which a government sponsors an insurance organization to assure capacity in the market at affordable prices, or to help assure overall economic stability. In these cases, the SOE could be considered Core, Very Important, or Important, and its credit rating would be established based on the relativity between the stand-alone assessment and rating of the sovereign.

In cases in which the SOE's rating is derived by notching down from the rating of the sovereign, the sovereign's local currency (LC) IDR is used as the starting point for establishing the SOE's LC IDR ratings, and the sovereign's foreign currency (FC) IDR is used as the starting point to establish the SOE's FC IDR ratings. Notching to the LC or FC IFS rating from the IDRs would follow Fitch's typical methodology based on recovery assumptions for policyholder obligations. In addition, any applicable country ceilings would apply.

Finally, this criteria with respect to SOEs does not apply to cases of temporary government support and related ownership (such as via a bailout), but rather when the ownership relationship is expected to be enduring.

I. Summary of Steps in Applying Group Rating Criteria

Step 1 — Develop Group Assessment

Develop a group assessment (GA), based on analysis of consolidated financial information and/or by combining analysis of various subsidiary companies. The criteria supporting this fundamental credit analysis is referenced in *Section I* of this report.

Step 2 — Assessment of Strategic Category (Willingness to Support)

For each insurance company to be rated, using the descriptions found on pages 55 of this report, classify as: Core (C), Very Important (VI), Important (I), or Limited Importance (LI).

Step 3 — Review Support Agreements (Willingness to Support)

If available, review any support agreements and classify as formal (FS) or informal (IS) per the descriptions on page 56 of this report.

If formal (FS), this may positively influence rating uplift in Step 7.

Step 4 — Barriers Based on Financial Strength (Ability to Support)

If the group assessment in step 1 is below 'A-', consider if this could limit the ability to the group to provide support. In some cases, a rating higher or lower than 'A-' should be used per the commentary on page 58–59.

If financial strength barriers (FB) exist, this may negatively influence rating uplift in Step 7.

Step 5 — External Barriers (Ability to Support)

Review if any regulatory, legal, or other external barriers exist that could materially affect the ability of the group to move capital if needed for support as per pages 58–59 of this report.

If external barriers (EB) exist and are extreme, a stand-alone approach (SA-Ap) is used and the stand-alone assessment (SAA) applies, unless a FS agreement is in place. If there is a FS, Step 7 is then used to determine its impact.

If EBs are of concern but do not warrant an SA-Ap, they may still negatively influence uplift in Step 7.

Step 6 — Develop Stand-Alone Assessments

If deemed useful, develop an SAA for group member(s). SAAs are typically only developed in select circumstances per page 60. The criteria supporting the fundamental credit analysis used to develop a SAA is referenced in *Section I* of this report.

Step 7 — Guidelines

I. Summary of Steps in Applying Group Rating Criteria (Continued)

Note: Guidelines demonstrate typical highest attainable rating.

Part A— If Core (C), Very Important (VI), or Important (I)

Strategic Category	Typical Rating Approach	What is No. Notches GA to SAA?	Initially, What is Highest Rating Relative to GA?	What is Highest Rating if There is an FS?	What Are Additional Constraints if Concerns Related to FB and/or EB? (Relative to SAA)
C	G-Ap	0–2 ^a	GA	GA	No Cap
		3–5	GA	GA	3 Above
		6+	GA	GA	4 Above
VI	PA-Ap	0–2	GA	GA	No Cap
		3–5	1 Below	GA	2 Above
		6+	3 Below	GA	3 Above
I	PA-Ap	0–2	GA	GA	No Cap
		3–5	2 Below	GA	1 Above
		6+	4 Below	GA	2 Above

^aIn many cases for Core subsidiaries, there will be no stand-alone assessment. In such cases, this row applies.

Part B — If Limited Importance (LI)

What is No. Notches GA to SAA?		If There Is a Formal Support (FS) Agreement, What is the Maximum Rating Uplift?	
Typical Rating?		If No FB (Down from GA)	If FB (Up from SAA)
0–2	SAA	GA	GA
3–5	SAA	1 Below	2 Above
6+	SAA	2 Below	3 Above

Final Step — Applies Only If Recovery Differences

If the various group members would be expected to have different recoveries in an insolvency, then their IFS ratings may need to be notched relative to the group IDR rating, per notching criteria referenced in *Section VI*.

Legend

Assessment Types

GA – Group Assessment
SAA – Stand-Alone Assessment

Support Agreement Types

FS – Formal Support
IS – Informal Support

Barriers to Support

FB – Financial Strength Barriers
B – External Barriers

Strategic Categories

C – Core
VI – Very Important
I – Important
LI – Limited Importance

Rating Approaches

SA-Ap – Stand-Alone Approach
PA-Ap – Partial Attribution Approach
G-Ap – Group Approach

- VI. Notching: Debt, Hybrids and Holding Companies**
 - A. Overview**
 - B. General Impact of Regulation**
 - C. Insurance Company to Holding Company Notching**
 - D. Debt and Hybrid Notching Relative to IDR**
 - E. “Other” Regulatory Impact: IFS/IDR Notching**
 - F. Sovereign Constraints Impact**
 - G. Distressed and Low-Rated Debt Notching**
 - H. Summary of Regulatory Classification Assumptions**
 - I. Notching Examples**

A. Notching — Overview

The concept of “notching” refers to the practice of establishing a given rating relative to a defined “anchor rating,” using guidelines linked to certain characteristics of the rating being notched. For purposes of insurance criteria, notching involves:

- **IFS Rating-Initial Anchor:** The typical first step in the notching process is to establish the IFS rating of the operating company(ies) as the initial anchor rating. The operating company IDR is then notched from the IFS rating.
- **Holding Company-Operating Company:** Notching considers the relationship between the IDR of an operating company(ies) and the IDR of the parent holding company. In such a case, the IDR of the operating company acts as the anchor rating.
- **Debt/Hybrid Ratings IDR:** Notching considers the relationship between the ratings of debt and hybrid instruments relative to the IDR of the issuer, whether an insurance operating company or holding company. The respective IDR(s) acts as the anchor.

The notching of the various debt and hybrid obligations is based primarily on the assumed relative recoveries of the obligation in the event of default. Higher recovering obligations are notched up from the IDR, and lower recovering obligations are notched down from the IDR. For hybrid securities, notching can also be influenced by risks related to features that could cause the hybrid to become nonperforming prior to a broader default by the company.

Typical notching of obligation ratings relative to the IDR for recovery only is shown in the table below.

Figure VI-1: Typical Notching Relative to IDR (Recovery Only)

Recovery Prospects	Degree of Notching	
	Investment Grade	Non-Investment Grade
Outstanding	+2	+3 (Secured), +2 (Unsecured)
Superior	+1	+2
Good	+1	+1
Average	0	0
Below Average	-1	-1
Poor	-2	-2 or -3

IDR – Issuer Default Rating.
Source: Fitch.

Global Systemically Important Insurers

From a notching perspective, Fitch does not currently treat G-SIFIs (or SIFIs) differently than non-G-SIFIs in their respective jurisdictions. However, Fitch expects that over time, regulatory standards and resolution schemes used for G-SIFIs will become clearer. If at some point Fitch concludes that the regulatory approach applied to G-SIFIs differs in key areas important to our notching assumptions, Fitch will update its criteria at that time.

In applying the above guidelines, Fitch typically uses baseline recovery assumptions for different classes and types of insurance obligations for issuers with IDRs of ‘BB-’ and above. These recovery assumptions can be found in the Figure VI-3 on page 78. In the insurance industry, the “Good” through “Poor” recovery categories cited above are most applicable given the limited use of secured debt by insurance entities.

For IDRs below ‘BB-’, Fitch aspires to develop specific bespoke (or tailored) recovery estimates, and may assign a Recovery Rating (RR) of ‘RR1’ through ‘RR6’. The methodology supporting bespoke recovery analysis and assignment of RRs can be found in *Section IX*. Notching guidelines for lower non-investment-grade IDRs and distressed debt is on page 83.

The remainder of this *Section VI* describes the assumptions and methodology supporting notching in the insurance industry.

***IFS Rating As Anchor/
Operating Company IDR***

The IFS rating of the operating company(ies) acts as the initial anchor rating in the notching process. The IFS rating is primarily established by application of the key rating factors discussed in *Section I* of these criteria.

The IFS rating typically assumes a recovery of “Good”. In this most common case, the IDR of the operating company will be notched down by one from the IFS rating. The IDR is meant to be “recovery neutral,” and is thus aligned with an “Average” recovery assumption.

Section VI-E discusses additional guidelines for when the recovery assumption for the IFS rating is other than Good.

B. General Impact of Regulation

The form of regulation establishes a theoretical foundation throughout these notching criteria. Fitch classifies regulation as being either “Group Solvency,” “Ring Fencing” or “Other.”

Group solvency regulation is assumed to exist when two broad conditions are met:

- Laws and rules are in place that protect policyholder interests by imposing a robust capital requirement at both the insurance operating company and consolidated group holdings levels.
- A group regulator and/or regulatory college system is in place to resolve a troubled group, and that key group members and local regulators would be expected to participate. In addition, no material group member, including the holding company, should have a clear legal ability to seek bankruptcy protection, or any other legal remedy, that places it outside the group regulator’s resolution authority.

Ring-fencing regulation is assumed to exist under these criteria when the regulatory intent is rooted in protecting policyholder interests by essentially isolating insurance operating companies from the risks of other group members, including both holding companies and non-insurance affiliates. Such ring fencing is often attained by some combination of:

- Imposing robust capital and other standards at the individual operating company level.
- Limiting the flow of capital or funds from the operating insurance company to group affiliates/shareholders via restrictive financial formulas, required pre-approvals by regulators or by other means.

While the Ring-Fencing approach is focused on isolating the operating company from other group risks, regulators typically still have authorities to monitor non-insurance risks.

In practice, some regulatory regime share elements of both group solvency and ring fencing. When in doubt, Fitch will err on the side of a Ring-Fencing classification, since Group Solvency is still relatively new, and ring fencing typically results in more conservative outcomes.

Other is used as the regulatory classification in cases when the solvency regime is limited in scope, which would be most common in certain offshore locales or some developing markets.

See summary of regulatory classification by country on page 84.

Holding Company Liquidity and Notching

Typically, Fitch will not compress notching in a Ring-Fence environment due to a holding company carrying high levels of cash (including highly liquid, high-quality, unaffiliated invested assets). Holding company liquidity is typically considered in ratings as part of the assessment of financial flexibility per *Section I-H* of these criteria.

However, on an exception basis, Fitch may compress holding company notching when holding company cash is large and enduring. Fitch would look for the following:

- Holding company cash has exceeded 75% of holding company debt/hybrid obligations in each of the past five years
- Management has made statements of its intention to maintain such high levels of holding company cash in at least the intermediate term (i.e. no plans to use to fund merger and acquisition activities or repurchase shares).
- IFS ratings are in the 'A' category or higher.

C. Insurance Company to Holding Company Notching

The notching between the insurance operating company IDR and its parent holding company IDR is based on the perceived difference in default risk between the two entities. This assessment will be heavily influenced by the style of regulation employed, as follows:

- Group Solvency regulation will generally result in an assumption by Fitch that core group members at both the operating and holding company levels share the same risk of default or failure, thus resulting in minimal to no notching between entity IDRs.
- Ring Fencing will generally result in an assumption that the default or failure risk among operating companies and the holding company can vary, resulting in greater use of IDR notching.

No notching is used in Other environments, but rating levels overall will typically be lower than in environments with more robust regulation.

Because the concept of regulatory colleges is still relatively new, application of a Group Solvency approach becomes less clear for global insurance groups. Fitch believes that in a global context, in many cases, local regulators will ultimately act in the best interest of local policyholders, even if to the detriment of the group as a whole. Thus, in such cases, a Ring-Fencing assumption may be used.

In practice, for global groups where more than 30% of earnings or capital comes from countries that are expected to ring fence (even if a Group Solvency approach is applied locally), notching down will typically be applied. Fitch would be most likely to assume cross-border Group Solvency for groups operating only within the European Union.

Figure VI-2: IDR Notching Guidelines — Insurance Company to Holding Company

	Regulatory Environment		Other
	Ring Fencing	Group Solvency ^a	
Investment Grade	-1	0	0
Non-Investment Grade	-2	-1	-1

^aIf foreign subsidiaries make up 30% or more of earnings/capital, ring fencing may be employed.

Source: Fitch Ratings.

Financial Leverage and Coverage Adjustments

For Ring-Fencing environments, holding company notching is additionally influenced by:

- The degree of financial leverage.
- Fixed-charge coverage.

For larger, debt-issuing organizations, Fitch views a financial leverage ratio (FLR, i.e. debt to capital) that falls within a range of 16%–30% to be typical for the insurance industry. In Ring-Fencing environments, leverage below this level may cause the agency to compress IDR notching by one notch (i.e. by uplifting the holding company IDR). Similarly, an FLR that is higher than 30% may lead Fitch to widen notching by one (i.e. by lowering the holding company IDR).

Strong or weak fixed-charge coverage can also influence relative default risk and notching in a Ring-Fencing environment. For a typical FLR in the 16%–30% range, Fitch would consider coverage to be unusually favorable at levels greater than 12.0x, and unusually unfavorable at

levels less than 3.0x. Fitch may consider tightening or widening IDR notching for unusually favorable or unfavorable fixed-charge coverage.

In addition to widening or narrowing notching in Ring-Fencing environments, particularly large variances in financial leverage or coverage can also move all operating and holding company ratings in tandem. This will happen when Fitch concludes that the noted leverage or coverage variance becomes material to the operating company IFS rating (as the initial anchor). The impact on the operating company IFS rating can be positive or negative. In Ring-Fencing environments, such variances would typically be especially large for the operating company IFS rating to be affected, as opposed to holding company notching being adjusted.

In Group Solvency environments, variations in leverage and coverage will not influence notching in cases when operating and holding company IDRs are aligned. However, leverage and coverage will have a higher weighting on the operating company IFS rating than in Ring-Fenced environments, with the IFS rating more sensitive to even moderate variances.

See *Section I-H* for median coverage ratios by rating category for non-life and life insurers.

Secured Debt

Use of secured debt in the insurance industry is fairly rare, since insurance is typically an investment-grade sector, and secured debt is most common for natural below investment-grade issuers.

If secured debt were to exist for an investment-grade (or high non-investment-grade) issuer, Fitch would employ a bespoke analysis to judge the recovery assumption (similar, but likely less detailed, than that discussed in *Section IX*.) However no Recovery Rating would be published unless the IDR was below 'BB-'.

In addition, if the secured debt was large and could have the first claim on a material portion of post-default assets, Fitch may use lower baseline recovery assumptions for more junior securities than shown to the right.

D. Debt and Hybrid Notching Relative to IDR

Recovery Assumptions

The notching of specific issue ratings relative to the IDR of the issuing entity, be it a holding company or insurance operating company, is first based on the expected recoveries of each debt issue/obligation in the event of a default. These are based on baseline assumptions shown in the table below when the IDR is 'BB-' and above, and may be based on specific bespoke RRs for IDRs below 'BB-'.

Figure VI-3: Baseline Insurance Recovery Assumptions

	Regulatory Assessment		
Obligation Type	Ring Fencing	Group Solvency	Other
Insurance Company			
Unsecured Senior Debt	Average	Average	Average or Below Average
Subordinated	Below Average	Below Average	Below Average or Poor
Deeply Subordinated	Poor	Poor	Poor
Holding Company			
Unsecured Senior Debt	Below Average	Below Average	Below Average or Poor
Subordinated	Poor	Poor	Poor
Deeply Subordinated	Poor	Poor	Poor

Source: Fitch Ratings.

Fitch generally assumes all debt issues of a given issuer share the same default risk, as reflected in the issuer's IDR. Relative recoveries among the various issues based on their legal seniority ranking dictate notching.

- Those debt instruments or obligations with Average recovery prospects (defined by Fitch as 31%–50%) may be rated equal to the IDR.
- High recovering secured debt can be rated two notches above the IDR at investment grade and three notches above (capped at 'BBB-') for non-investment grade.
- Obligations with the weakest recovery prospects can be rated up to three notches below the IDR based on expected Poor recoveries at default (at non-investment grade).
- Hybrids with significant Nonperformance features can be notched lower than implied by recovery alone.

Generally, for a given recovery expectation, the degree of notching may tighten relative to the IDR as one moves up the rating scale, and widen moving down the scale, in order to increase the weighting of recoveries on below investment-grade ratings and increase the emphasis on probability of default on investment-grade ratings. See Figure VI-1 for details.

Senior Debt Recoveries and Notching

For holding companies, Fitch typically assumes that unsecured senior debt recoveries are at a level of Below Average and for insurance operating companies the unsecured senior debt recovery is assumed to be Average. The more punitive assumption for holding companies reflects an assumption of holding company debt being exposed to deeper effective subordination than debt carried at the operating company level.

This is because funds supporting recoveries for the holding company of a failed insurance company subsidiary may be limited to holding company-level assets or the funds from any other non-insurance subsidiaries. While in some cases these can prove to be significant, Fitch believes that they will be quite modest in a majority of cases.

Bancassurance Recovery Assumptions

In markets that employ bancassurance, Fitch will typically use insurance recovery assumptions for the various insurance operating and holding company liabilities. However, on an exceptional basis, rating committees may determine to use bank-like recovery assumptions for debt and hybrid obligations of an insurance holding company in a bancassurance group. This would occur if the committee concludes the holding company would be subject to a bank-like resolution. Bank-like recovery assumption would rarely, if ever, be applied to the insurance operating company level.

The table below illustrates typical notching relative to the IDR for unsecured senior debt of insurance organizations at an investment-grade IDR:

Figure VI-4: Senior Debt — Typical Investment-Grade Notching

	Regulatory Environment		
Issuer Type	Ring Fencing	Group Solvency	Other
Insurance Company			
Baseline Recovery	Average	Average	Average or Below Average
Notching Relative to IDR	0	0	0 or –1
Holding Company			
Baseline Recovery	Below Average	Below Average	Poor
Notching Relative to IDR	–1	–1	–2
Source: Fitch Ratings.			

Source: Fitch Ratings.

Subordinated Debt Recoveries and Notching

Like senior debt, straight subordinated debt instruments (i.e. those without Non-performance features) are notched relative to the IDR based on their baseline recovery assumptions.

At the operating company level, Fitch assumes a Below-Average recovery for subordinated debt in the event of default. At the holding company level, consistent with its expectations of lower recoveries of senior debt, Fitch assumes an even lower level of recoveries for subordinated debt, at Poor. Typical notching for straight subordinated debt is illustrated below:

Figure VI-5: Subordinated Debt^a — Typical Investment-Grade Notching

Issuer Type	Regulatory Environment		
	Ring Fencing	Group Solvency	Other
Insurance Company			
Baseline Recovery	Below Average	Below Average	Below Average or Poor
Notching Relative to IDR	−1	−1	−1 or −2
Holding Company			
Baseline Recovery	Poor	Poor	Poor
Notching Relative to IDR	−2	−2	−2

^aTable illustrates subordinated debt that does not contain nonperformance features. See Hybrid Notching for subordinated debt with Non-performance features.

Source: Fitch Ratings.

Hybrid Notching

Hybrid notching involves two steps:

- Notching is first established based on recovery expectations per Figure VI-5.
- Hybrids are additionally notched if they include Nonperformance features, such as coupon deferrals/omission, principal write-downs or contingent conversion.

Typically, the existence of a Nonperformance feature may cause Fitch to notch down the hybrid from the issuer's IDR by one or more additional notches, compared with the notching of like ranking/recovering debt per Figure VI-5. Generally, the more easily activated the feature is perceived to be, the greater the additional notching.

Typically, hybrid features that are based on management discretion are considered to be less likely to be triggered. Those where discretion is given to regulators, or where triggering is mandatory based on a conservative financial metric and without other constraints, are generally considered more likely to be triggered.

U.S. Surplus Notes and Japanese Kikin

Surplus notes issued by U.S. insurance companies and kikin issued by Japanese insurance companies are generally notched down by one from the IDR of the insurance company on an assumption of Below Average recoveries (1 notch), and Minimal Nonperformance risk (0 notches). Regulators have historical appeared hesitant to impose deferrals on these instruments except under relatively severe stress.

However, if the financial leverage ratio of the insurance company (counting surplus notes or kikin as debt) exceeds 15%, the surplus notes or kikin will typically be notched down by two, as in such a case deferral risk is assumed to increase into the Moderate category.

Regulatory discretion over hybrid features is more typically present in jurisdictions using a Group Solvency approach, and where hybrids can be potentially included in regulatory capital, based on their Nonperformance features. It is less prevalent in Ring-Fencing environments, such as for U.S. holding companies that issue hybrids.

Fitch's insurance criteria for Non-performance notching is derived from Section IV.2.3 of Fitch's bank criteria report *Global Bank Rating Criteria* (March 2015). Readers should also be familiar with the noted section of the bank report since aspects of it are incorporated into these insurance criteria by reference and provides a more detailed explanation of various concepts.

Non-performance risk is classified into one of three broad categories, as follows:

- **Minimal:** Hybrid feature is not expected to trigger until the point at which a company may otherwise fail or default, such as when a mandatory trigger is tied to a capital ratio level that aligns with regulatory intervention. It would also apply in most cases when a trigger is left to the discretion of management and/or the trigger is highly complex with look-back features, etc., that make the ability to trigger questionable.
- **Moderate:** Used for cases that fall between Minimal and High.
- **High:** Hybrid feature is expected to be triggered well in advance of failure, and the regulator has full discretion to enact a trigger and would be expected by Fitch to enact the trigger if circumstances warrant. A trigger linked to a "buffer" capital ratio level that is well above a regulatory minimum, and is only modestly below a level that would be considered a very safe target.

The following table illustrates the degree of additional notching employed for Nonperformance risk.

Figure VI-6 — Hybrid Nonperformance Risk Notching

Risk Levels	Additional Notching	Examples
Minimal	0 or 1 ^a	Many legacy hybrids, Solvency 2 Tier 3 hybrids, and weaker Tier 2 hybrids, such as those with look-back features. Capital ratio triggers include 100% of Solvency 1 ratios, 100% of Solvency 2 MCR, 100% of US NAIC RBC ACL, 120% of Canada MCCR and 200% of Japan SMR.
Moderate	1 or 2 ^a	Stronger Solvency 2 Tier 2 hybrids, such as those with mandatory triggers that are fairly conservative but may include some constraints. Example capital triggers include 100% of Solvency 2 SCR, 150% of US NAIC RBC ACL and 150% of Canada MCCR.
High	3 or More	Solvency 2 Tier 1 hybrids with very easily activated trigger such as full regulator coupon discretion, or capital ratio trigger set well above regulatory minimums and without other constraints.

^aFor Minimal, 0 is used as the baseline in Group Solvency environments, with 1 used as the baseline in Ring-Fencing environments. For Moderate, 1 is the baseline for Group Solvency and 2 is used as the baseline for Ring Fencing. Note: Regulatory environment is defined based on country of hybrid issuer, and Group Solvency will be used for hybrid notching in a country employing Group Solvency even if Ring Fencing is employed for holding company notching due to the "30% foreign capital/earnings" guideline. MCR – Minimum capital requirement. ACL – Authorized control level. MCCR – Minimum continuing capital and surplus requirements. SMR – Solvency margin ratio. SCR – Solvency capital requirement.

Source: Fitch Ratings.

IFS Recovery Assumptions

The typical assumption of Good for IFS recoveries is based on Fitch's belief that when regulation is effective, regulators will intervene early enough such that assets will be preserved enterprise-wide in a distressed scenario. Thus, policyholder or reinsurance obligations, as the largest and most dominant liability, will share in the strong recoveries of the enterprise as a whole, whether afforded priority or not.

Recovery expectations tied to IFS policyholder obligations do not consider recoveries available to a policyholder from regulatory guarantee funds. They only reflect recoveries available from the assets of the insurance or reinsurance company itself. Similarly, recoveries available from the provision of security to collateralize reinsurance balances to specific unaffiliated ceding companies are not considered.

E. 'Other' Regulatory Environment: IFS/IDR Notching

As noted, when regulation is considered to be effective (classified as Group Solvency or Ring Fencing), Fitch uses a recovery assumption of Good for the IFS rating, and notches down the IDR from the IFS rating by one notch. However, when the regulatory classification is Other, this can affect both the level of the IFS rating and can also influence notching to the operating company IDR.

The weaker the regulatory environment generally, and the lower the IFS recovery assumption, the lower the IFS rating will be established. All else equal, the IFS will be pulled down by one notch for an Average recovery assumption, by two for Below Average recovery and by three for a Poor recovery. The pull down effect could be even greater if regulatory weaknesses are expected to impact the insurer's financial strength beyond recovery.

Fitch's cross-sector criteria report, *Country Specific Treatment of Recovery Ratings* (June 2013), also has relevance to the level of the IFS rating tied to recovery assumptions. This report discusses caps that can be placed on recovery assumptions in jurisdictions where enforceability of credit protections is limited or questionable.

A regulatory classification of Other can also affect the notching of the operating company IDR, as follows (the IDR is "recovery neutral," and thus, is thus always aligned with a recovery assumption of Average).

Figure VI-7a: Operating Company IDR Rating Notching — For Other Regulatory Environment

	Recovery Assumption for IFS Rating		
	Average	Below Average	Poor
IDR Relative to IFS	0	+1	+2

IDR – Issuer Default Rating. IFS – Insurance Financial Strength.
Source: Fitch Ratings.

F. Sovereign Constraint Impact

The notching exercise is applied to an anchor rating (typically the operating company IFS rating) that assumes no sovereign constraint. Instead, if a sovereign constraint (or country ceiling) is applicable (see *Section I-B*), it is applied as the last step in the ratings process.

For example, assume a situation where Fitch employs a sovereign constraint of 'A-'. Additionally assume an unconstrained local currency operating company IFS rating of 'A+' for a given issuer. Also assume the goals of the notching exercise are to establish an operating company IDR rating based on a Good recovery assumption for the IFS, a holding company IDR under Group Solvency, an unsecured senior debt rating of the holding company based on a Below Average recovery and a holding company hybrid rating using a Poor recovery and Moderate (two notch) Nonperformance assumption.

The following table illustrates the two step process.

Figure VI-7b: Example of Two-Step Notching Process/Sovereign Constraints

Rating Type (Notches)	Step 1 Unconstrained	Step 2 Apply Constraint
IFS Rating (Anchor)	A+	A-
Op Co IDR (-1)	A	A-
Hold Co IDR (0)	A	A-
Unsecured Senior (-1)	A-	A-
Hybrid (-4)	BBB-	BBB-

IDR – Issuer Default Rating.
Source: Fitch Ratings.

G. Distressed and Low-Rated Debt Notching

Fitch uses the guidelines in the table below to assign issue ratings to defaulted and distressed debt issues, as well as performing debt rated 'B+' and below.

Per Fitch methodology, the issue rating for defaulted debt is based on the RR assigned to the issue (see *Section IX*). For example, looking at the columns for IDRs of 'RD' and 'D', a defaulted debt issue with a RR of 'RR2' may be rated 'CCC'. A defaulted issue with a 'RR3' may be rated 'CC'.

As can be observed, notching for debt instruments at the lowest end of speculative grade is compressed. The debt instruments assigned to bonds of issuers that have defaulted, or are very close to default, show little distinction between 'RR4' and 'RR6' recoveries.

At this point, it is generally useful for the reader to refer to the published RR in addition to the instrument rating, as is an instrument rated 'C' were to default this may imply an expected loss anywhere between 50% (if it is rated 'C/RR4') and 100% (if it is rated 'C/RR6').

Figure VI-8: 'B' and Below IDR/Debt Instrument Mapping

IDR	Distressed and Defaulted Bonds							
	B+	B	B-	CCC	CC	C	RD	D
RR1	BB+	BB	BB-	B+	B	B-	B-	B-
RR2	BB	BB-	B+	B	B-	CCC	CCC	CCC
RR3	BB-	B+	B	B-	CCC	CC	CC	CC
RR4	B+	B	B-	CCC	CC	C	C	C
RR5	B	B-	CCC	CC	C	C	C	C
RR6	B-/CCC	CCC/CC	CC/C	C	C	C	C	C

IDR – Issuer Default Rating.

Source: Fitch Ratings.

H. Summary of Regulatory Classification Assumptions

Figure VI-9: Regulatory Classification Summary

(The following apply to primary insurers and reinsurers, and typically exclude captives)

Country	Classification ^a
Australia	Group Solvency
Barbados	Other
Belarus	Other
Bermuda	Group Solvency
Brazil	Ring Fencing
Canada	Group Solvency
Cayman Islands	Ring Fencing ^b
Chile	Ring Fencing
China	Group Solvency
Colombia	Ring Fencing
Costa Rica	Ring Fencing
Dominican Republic	Other
El Salvador	Other
European Economic Area	Group Solvency
Guatemala	Other
Honduras	Other
Hong Kong	Ring Fencing
Indonesia	Ring Fencing
Japan	Group Solvency
Kazakhstan	Other
Malaysia	Ring Fencing ^c
Mauritius	Ring Fencing
Mexico	Ring Fencing
New Zealand	Ring Fencing
Nicaragua	Other
Panama	Other
Peru	Ring Fencing
Russia	Other
Singapore	Ring Fencing ^c
South Africa	Group Solvency
South Korea	Ring Fencing
Sri Lanka	Ring Fencing
Switzerland	Group Solvency
Taiwan	Group Solvency
Thailand	Ring Fencing
United States	Ring Fencing
Venezuela	Other

^aRegulatory classifications shown here have relevance only from the perspective of these notching criteria. No other inferences should be drawn. Some jurisdictions have characteristics that include elements of "ring fencing" and "group solvency". In these cases, Fitch set the classification based on which elements were most important to Fitch's general notching principals. ^bApplies only to Class D reinsurers as defined by Cayman Islands regulations. All other classes are Other. ^cIf enhanced capital standards at the parent/holding company level are implemented within Malaysia's and Singapore's insurance regulations as expected in 2018 and 2017, respectively, the country regulatory classification will likely change to Group Solvency at that time. Prior to that, rating committees will determine on a group by group basis whether notching should be based on Ring Fencing or Group Solvency assumptions based on the nature of any specific capital standards currently put into place by the regulator for a specific group at the consolidated parent/holding company level.

Source: Fitch Ratings.

I. Notching Examples

The next page includes tables showing how notching would work under both the ring-fencing and group solvency regulatory regimes.

- The examples include four cases of debt issuance: no debt is issued, debt is issued by a holding company, debt is issued by the operating company and debt is issued by both the operating and holding company.
- The four cases are shown at both investment grade, assuming an anchor IFS rating of 'A+' for the insurance operating company, and at non-investment grade using a 'BB+' IFS rating.

In all four cases, the IFS rating assumes a recovery of Good, and thus, the operating company IDR is shown as notched down by one from the IFS rating. All other notching amounts (i.e. +1 or +2) are shown relative to the IDR of the operating company. In all cases, Fitch assumed average levels of financial leverage and fixed-charge coverage such that these characteristics would not influence notching.

Unsecured senior and subordinated debt is illustrated to be straight debt, with no deferral or other loss absorption features. Thus, the notching illustrated is influenced only by assumed recovery levels.

Hybrids are shown for the Minimal and High Nonperformance classifications only.

Figure VI-10: Notching Examples

I. Ring-Fencing Environment:

Rating Filing Environment		IG Case		Non-IG Case	
1. No Debt Issued					
Insurance Operating Company					
IFS Rating (Good)	A+	—	BB+	—	
IDR of Op Co	A	(-1)	BB	(-1)	
2. Debt Issued by Holding Company					
Insurance Operating Company					
IFS Rating (Good)	A+	—	BB+	—	
IDR of Op Co	A	(-1)	BB	(-1)	
Holding Company					
IDR of Hold Co	A-	(-1)	B+	(-2)	
Unsecured Senior (Below Average)	BBB+	(-2)	B	(-3)	
Subordinated Debt (Poor)	BBB	(-3)	B-/CCC+	(-4 to -5)	
Hybrid — Minimal Nonperformance Risk (Poor)	BBB/BBB-	(-3 to -4)	B- to CCC	(-4 to -6)	
Hybrid — High Nonperformance Risk (Poor)	BB	(-6 +)	CCC-/CC	(-7 to -8 +)	
3. Debt Issued by Insurance Company					
Insurance Operating Company					
IFS Rating (Good)	A+	—	BB+	—	
IDR of Op Co	A	(-1)	BB	(-1)	
Unsecured Senior (Average)	A	0	BB	0	
Subordinated Debt (Below Average)	A-	(-1)	BB-	(-1)	
Hybrid — Minimal Nonperformance Risk (Poor)	BBB+/BBB	(-2 to -3)	B+ to B-	(-2 to -4)	
Hybrid — High Nonperformance Risk (Poor)	BB+	(-5 +)	CCC+/CCC	(-5 to -6 +)	
4. Debt Issued by Both Insurance Company and Holding Company					
Insurance Operating Company					
IFS Rating (Good)	A+	—	BB+	—	
IDR of Op Co	A	(-1)	BB	(-1)	
Unsecured Senior (Average)	A	0	BB	0	
Subordinated Debt (Below Average)	A-	(-1)	BB-	(-1)	
Hybrid — Minimal Nonperformance Risk (Poor)	BBB+/BBB	(-2 or -3)	B+ to B-	(-2 to -4)	
Hybrid — High Nonperformance Risk (Poor)	BB+	(-5 +)	CCC+/CCC	(-5 to -6+)	
Holding Company					
IDR of Hold Co	A-	(-1)	B+	(-2)	
Unsecured Senior (Below Average)	BBB+	(-2)	B	(-3)	
Subordinated Debt (Poor)	BBB	(-3)	B-/CCC+	(-4 or -5)	
Hybrid — Minimal Nonperformance Risk (Poor)	BBB/BBB-	(-3 or -4)	B- to CCC	(-4 to -6)	
Hybrid — High Nonperformance Risk (Poor)	BB	(-6 +)	CCC-/CC	(-7 to -8+)	

IFS – Insurer Financial Strength. IDR – Issuer Default Rating. IG – Investment grade. Non-IG – Non-investment grade.

Continued on next page.

Source: Fitch Ratings.

Figure VI-10: Notching Examples (Continued)

II. Group Solvency Environment:

	IG Case		Non-IG Case	
1. No Debt Issued				
Insurance Operating Company				
IFS Rating (Good)	A+	—	BB+	—
IDR of Op Co	A	(-1)	BB	(-1)
2. Debt Issued by Holding Company				
Insurance Operating Company				
IFS Rating (Good)	A+	—	BB+	—
IDR of Op Co	A	(-1)	BB	(-1)
Holding Company				
IDR of Hold Co	A	(0)	BB-	(-1)
Unsecured Senior (Below Average)	A-	(-1)	B+	(-2)
Subordinated Debt (Poor)	BBB+	(-2)	B/B-	(-3 to -4)
Hybrid — Minimal Nonperformance Risk (Poor)	BBB+/BBB	(-2 to -3)	B to CCC+	(-3 to -5)
Hybrid — High Nonperformance Risk (Poor)	BB+	(-5 +)	CCC/CCC-	(-6 to -7+)
3. Debt Issued by Insurance Company				
Insurance Operating Company				
IFS Rating (Good)	A+	—	BB+	—
IDR of Op Co	A	(-1)	BB	(-1)
Unsecured Senior (Average)	A	0	BB	0
Subordinated Debt (Below Average)	A-	(-1)	BB-	(-1)
Hybrid — Minimal Nonperformance Risk (Poor)	BBB+/BBB	(-2 to -3)	B+ to B-	(-2 to -4)
Hybrid — High Nonperformance Risk (Poor)	BB+	(-5 +)	CCC+/CCC	(-5 to -6+)
4. Debt Issued by Both Insurance Company and Holding Company				
Insurance Operating Company				
IFS Rating (Good)	A+	—	BB+	—
IDR of Op Co	A	(-1)	BB	(-1)
Unsecured Senior (Average)	A	0	BB	0
Subordinated Debt (Below Average)	A-	(-1)	BB-	(-1)
Hybrid — Minimal Nonperformance Risk (Poor)	BBB+/BBB	(-2 or -3)	B+ to B-	(-2 to -4)
Hybrid — High Nonperformance Risk (Poor)	BB+	(-5 +)	CCC+/CCC	(-5 to -6+)
Holding Company				
IDR of Hold Co	A	(0)	BB-	(-1)
Unsecured Senior (Below Average)	A-	(-1)	B+	(-2)
Subordinated Debt (Poor)	BBB+	(-2)	B/B-	(-3 or -4)
Hybrid — Minimal Nonperformance Risk (Poor)	BBB+/BBB-	(-2 or -3)	B to CCC+	(-3 to -5)
Hybrid — High Nonperformance Risk (Poor)	BB+	(-5 +)	CCC/CCC-	(-6 to -7+)

IFS – Insurer Financial Strength. IDR – Issuer Default Rating. IG – Investment grade. Non-IG – Non-investment grade.
Source: Fitch Ratings.

VII. Start-Up and Runoff Organizations

Start-Up and Runoff Organizations

Start-Up Company Considerations

In some cases, Fitch assigns IFS ratings or IDRs to insurance companies that are commencing operations or have a limited track record. Reflecting this risk element:

- Fitch rarely assigns start-up IFS ratings or IDRs, before taking into account the impact of any parent or group support above the 'A' category.
- Many well-capitalized, well-run institutions with a limited history would be rated in the 'BBB' category for IFS or IDR.

In the cases of start-up organizations or those with a limited operating history, the agency assesses management's track record, data, and experience, as well as placing greater weight on a critical assessment of forward-looking forecasts and budgets.

Corporate governance and ownership factors also play a more important role in the assessment of a start-up. This includes the alignment of incentives between the management and owners but also the owners' identity, resources, investment style, exit strategy, and investment track record. Owners that have limited resources, an aggressive exit strategy, and high return expectations are usually less favorable for the insurer's rating.

In rating such firms, the degree of judgment that is required in the rating process is increased and the rating is heavily affected by Fitch's perception of management's ability to reach its financial projections.

The agency generally views a limited track record for a firm as elevating the risk profile relative to peers, reflecting the challenges of attracting quality new business as well as potential operational difficulties. These challenges are often less significant and long-lasting for industry segments where business is short-tailed, customers are more opportunistic, and significant data is publicly available to help quantify and assess risks (e.g. catastrophe reinsurers.)

Where Fitch assigns a rating to an insurer based on its stand-alone profile and with less than five years of audited information available, this may be disclosed. The table below shows the impact for life and non-life insurers in developed markets.

Rating constraints for a limited track record are lessened as the company matures, and in most (but not all) cases they are no longer applied after five years. The degree of constraint may be reduced incrementally as a track record is built.

Figure VII-1: Ratings Range Based on Years of Operations

IFS Rating Category	AAA	AA	A	BBB	<BBB
Senior Debt Rating Category	AA	A	BBB	BB	<BB
Seasoned	←				→
Limited History			←		→

Runoff Company Considerations

In some cases, Fitch assigns ratings to insurance companies that have ceased operations and are voluntarily running off their books of business. The analysis employed by Fitch for such entities would include review of the key rating factors discussed in *Section 1* but with recognition that the lack of an ongoing franchise carries additional risks. These would include an inability to grow new profitable businesses to offset losses on existing business should losses develop, as well as challenges in raising capital if needed, among others.

- Typically, to reflect these characteristics, IFS ratings and IDRs of runoff organizations would not exceed the 'BBB' category.
- There could be limited exceptions to this, but such exceptions would be expected to be infrequent.

The concepts just discussed do not apply to active companies whose business model involves buying and then running off blocks of business from third-party insurers. Fitch considers such companies to be active insurance organizations.

VIII. Short-Term Ratings

Short-Term Ratings

The time horizon of short-term ratings is typically defined nominally as 13 months, reflecting the 397-day maximum period associated with most types of short-term debt.

The level of a short-term rating is primarily derived from the issuer's long-term ratings, using the linkages outlined in the table below. These linkages reflect the inherent importance of liquidity and near-term concerns within Fitch's long-term ratings assessments.

For long-term ratings of 'A+', 'A-', and 'BBB', one of two short-term ratings can be applied. The lower of the two short-term ratings may be used unless the issuer demonstrates exceptional liquidity characteristics that are expected to endure.

Debt Issue Ratings

Short-term debt issue ratings of investment-grade issuers, such as commercial paper, typically do not consider recovery, and thus only reflect default risk. Accordingly, debt issue ratings may be based on linkages to the long-term IDR of the issuer and not the unsecured senior debt rating.

Short-Term IFS Ratings

While most debt issue ratings are linked to the long-term IDR, the short-term IFS rating is linked to the long-term IFS rating.

Liquidity Backup

Due to refinancing risks, including cases of systemic market disruptions, Fitch's analysis of a commercial paper issuer's liquidity may consider backup. Fitch typically expects full (100%) backup of commercial paper and other short-term obligations, regardless of the credit rating of the issuer. While backup is most commonly provided in the form of committed bank lines, it may also be in the form of cash and high-quality marketable securities, parent-provided liquidity support or other clearly reliable alternatives.

The presence of a "material adverse change" (MAC) clause and covenants in bank provided back-up facilities complicates the analysis of liquidity, and the assessment of the sufficiency of the back-up facilities. These are addressed by the rating committee on a case by case basis.

Material deficiencies in back-up may result in downgrade of all long-term and short-term ratings, or in some cases an inability by Fitch to rate the short-term obligation.

Less Liquid Markets

The above guidelines are most applicable in the U.S. and euro zone markets, where there are large and well-developed markets for short-term debt. In other markets that are generally less liquid, rating committees may adjust these guidelines based on judgment related to unique circumstances.

Figure VIII-1: Relationship Between Long-Term and Short-Term Ratings

Long-Term	Short-Term
AAA	F1+
AA+	F1+
AA	F1+
AA-	F1+
A+	F1 or F1+
A	F1
A-	F2 or F1
BBB+	F2
BBB	F3 or F2
BBB-	F3
BB+ to B-	B
CCC to C	C
RD/D	RD/D

IX. Recovery Analysis

- A. Overview**
- B. Estimating the Value Available to Creditors**
- C. Estimate the Creditor Mass**
- D. Determine the Distribution of Value**

A. Recovery Analysis — Overview

For issuers with IDRs at 'B+' and below, Fitch aspires to perform a tailored (also known as "bespoke") recovery analysis for each group of obligations of the issuer. Fitch strives to assign RR to rated debt and hybrid issues at the same time as the IDR is lowered to 'B+' or lower.

As a bespoke analysis, Fitch's specific recovery calculations may vary from case to case, reflecting different circumstances, expected asset recoveries, and levels of priority for creditors. However, Fitch uses the same broad methodology in each case with three steps:

- Estimate the value available to creditors.
- Estimate the creditor mass.
- Determine the distribution of value.

The procedures are used to approximate the value that may be available to creditors in the event of a default. This is then allocated to the various creditor classes in accordance with their expected priority ranking. It is noteworthy that estimating the value of an insurance enterprise often involves a high degree of judgment. In addition, the allocation of this value to various creditor classes can involve significant uncertainty, especially in emerging markets or when considering multinational insurance groups.

In select situations, Fitch may determine that at the time an IDR is lowered it cannot assign a RR. This may be due to Fitch's belief that it does not possess the necessary information to conduct a robust recovery analysis, or that it has not had sufficient opportunity to adequately study the information available to make a meaningful determination of the RRs.

In these cases, Fitch may move without delay to lower the IDR to the appropriate level and may communicate when it expects to assign RRs to the rated securities of the issuer. In such circumstances, Fitch may place the related issue ratings on Rating Watch until RRs can be determined.

Ultimately, if Fitch determines that a robust bespoke recovery analysis cannot be performed, Fitch may not assign a RR. Instead, the agency may either: 1) use a baseline recovery assumption in notching the issue rating and cite an inability to arrive at a RR as a limitation of the issue rating, or 2) withdraw the issue rating.

B. Estimating the Value Available to Creditors

The value available to creditors can be established through several possible methods. For insurance companies, each of the steps may be heavily influenced by the role of the regulator.

- Capital protections or prevention of payments to the holding company could build a capital cushion at the regulated insurance company aiding its relative recovery.
- Further, the recovery value to policyholders is often best protected if the insurance operating entity can be sold reducing potential deterioration of asset values.
- Differences may also occur between life and non-life given the longer tenor of life liabilities.

The specific valuation technique used in determining RRs may be based on Fitch's view as to the most likely prospect for the entity post any default. Analysts may conduct both the liquidation and enterprise value approach, which, in theory, should have similar outcomes. If outcomes are substantially different, analysts and rating committees may consider such differences judgmentally.

Liquidation Approach

Given their regulated status, insurers do not tend to be liquidated in the same way as corporates. Instead they are generally wound up in accordance with legislation and regulation that differs by jurisdiction. For simplicity, all cases where the group or entity relies on its own existing assets to pay off creditors are referred to as a liquidation approach.

In valuing an insurer, Fitch may make various adjustments to the balance sheet to reflect:

- Projections of what the balance sheet may look like at the time of default.
- Realistic revaluations of assets, especially where some assets may be sold at "fire sale" prices.
- The loss of value of some assets at the time of winding up (e.g. goodwill, deferred tax assets).

Therefore, the agency makes various "haircuts" to assets that vary from case to case. For example, if an insurer's low IDR largely reflects a high level of risk associated with some of its investment assets, these investment assets may be haircut to reflect their possible value at the time of default. On the other hand, if the main ratings concern is that an increase in liabilities (i.e. claim/benefit reserves) would be the most likely reason for the insurer's default, and asset quality is high, asset haircuts are likely to be smaller.

The following additional six steps/guidelines are relevant when using a liquidation approach:

- Assets are subject to a haircut to reflect the fact that the assets may have a lower valuation at time of default and illiquid investments may need to be sold at a significant discount. Haircuts may vary by accounting practices within jurisdictions. Haircuts in jurisdictions with assets based on historic valuations may be more severe than those in marked-to-market jurisdictions. In addition, time to liquidation assumed may also be a material factor. Life insurance companies have long-dated tenors, which may allow greater leeway in liquidation versus a property/casualty company that may be pressured to meet payments much sooner.
- Cash held at the holding company may be assumed to be paid down into the operating company as a capital investment prior to default, if pressures are assumed to reside at the operating company level.

Figure IX-1: Asset Haircuts

Asset	Characteristics	Discount (%)
Cash — Operating Company	Low risk but position may deteriorate prior to default.	0–25
Cash — Non-Operating Holding Company	Holding company cash generally assumed to be used or downstreamed to operating company prior to default.	100
Government Securities	Low risk and liquid.	2–3
Reinsurance Recoverables	Variable quality and can be vulnerable to dispute risk or overstatement.	10–40
Corporate Debt Securities	Mainly low risk, but variable liquidity.	15–50
Structured Finance Securities	Wide range of quality, but limited liquidity.	15–100
Real Estate And Property	Illiquid and potentially volatile valuation.	20–60
Intragroup Receivables	Depends on credit quality of rest of group.	25–100
Equities	Variability in liquidity and volatility.	15–100
Amounts Due From Brokers/Policyholders	Amounts may be withheld.	50–70
Fixed Assets — Tangible	Illiquid and variable value.	15–50
Associates And Joint Ventures	Illiquid and variable value.	20–100
Intangible Assets	Illiquid and questionable value in distress.	70–100
Value of Business in Force	Illiquid and variable value.	40–100

Note: These ranges are provided for indicative purposes only. As a bespoke analysis, the agency may use other asset valuations where considered more appropriate.

- Deferred tax assets and other intangible assets may be written off. Exceptions to this may include future profitability expectations on a portion of the insurer's business despite a general default. Where profitability is anticipated on an existing book of business, a conservative portion of deferred acquisition costs (DAC)/intangibles may be included as an asset of the company.
- Any anticipated future profitability from the commutation of business may not be included as an asset of the company as such profits typically reflect the time value of money as well as own credit risk.
- Off-balance sheet assets such as guarantees may be added to investments.
- The cost of administration is captured by deducting an additional 2% of assets from total recoveries, although this may vary from country to country as appropriate.

As a bespoke analysis, the asset haircuts employed may vary according to circumstances. However, while not prescriptive, the haircuts in the table above are considered to be typical.

Enterprise Valuation

In some cases, instead of, or in addition to, a liquidation analysis, the agency may make estimates as to the valuation of certain insurance operations as a whole. This would be especially true where the recovery analysis is being performed for a holding company with distinct subsidiaries that could be sold individually.

In making such enterprise valuations, Fitch may take account of the fact that a defaulted entity is liable to be a “forced” seller, and there may be some reputational, operational, financial, or other linkages that may affect the valuation.

- In determining the valuation of insurance operations to be sold, Fitch may consider quoted market prices where peers are available or else use proxies for valuation, such as multiples of earnings, book value, or where available, a percentage of published embedded values.

- The multiples used may vary from case to case but would commonly fall within the ranges in the table below.

Figure IX-2: Valuation Multiples — Illustrations

Valuation Method	Typical Multiples (x)
Price/Earnings Multiple	3.0–10.0
Book Value	0.8–1.1
Embedded Values	0.7–0.95

Note: These ranges are provided for illustrative purposes only. During certain periods of extreme market or economic conditions, reasonable multiples could fall outside of the above ranges. As a bespoke analysis, the agency may use other valuation methodologies where considered more appropriate. Where such other valuation methods above are employed, the multiples used may fall outside of these ranges.

The use of multiples may be influenced by local market conditions, regulatory conditions, and the availability of multiples from peers. In all cases, multiples are subject to a prudence principle that acts to limit the multiple at the time of peak valuations, which reflect the collapse in multiples at troughs.

Fitch may use relatively conservative valuation multiples when market valuations are at historical peaks. Similarly, when markets are so depressed or disrupted that they are essentially illiquid (for example, during the 2008 financial crisis), Fitch's recovery multiples may be higher than observed market multiples, if any are available. However, in all cases, Fitch will continue to be conservative in its assumptions.

C. Estimate the Creditor Mass

Fitch's general approach is to classify the creditors according to their seniority such that pari passu creditors are grouped together. Fitch may make adjustments to the creditor profile to reflect:

- Projected changes in the balance sheet prior to default.
- Accounting adjustments such as ensuring that liabilities reflect the amount owed rather than a fair value (that is written down to reflect the issuer's own credit risk).

Applying a "shock" to liabilities mirrors the effect of the haircutting of assets and reflects the fact that some creditor classes may be expected to expand prior to default.

For example, the agency may shock insurance liabilities to reflect that results may deteriorate either as part of the cause or as an effect of the default. Where an entity has a history of reserve deterioration or poor underwriting and the entity is considered most likely to default due to liability (as opposed to asset) difficulties, the agency may shock policyholder liabilities more than in other circumstances.

Typical categories and shocks used are shown in the table below.

Figure IX-3: Calculation of Creditor Mass

Priority	Balance sheet Category	Shock (% Increase)	Notes
1	Secured/Preferred Creditors	—	
	Unearned Premium Reserve	—	
	Provision For Outstanding Claims — Non-Life	5–20	Reflects reserve deterioration or poor performance prior to default
	Long-Term Health Insurance Reserves	0–10	Reflects reserve deterioration or poor performance prior to default
	Long-Term Life Reserves	0–10	Reflects reserve deterioration or poor performance prior to default
2	Policyholder Obligations		
	Due To Related Parties	—	
	Due To Reinsurers	—	
	Creditors and Accrued Charges	—	
	Senior Unsecured Debt	—	
	Bank Lines And Overdrafts	Variable	Reflects drawing down of committed bank lines prior to default
3	Unsecured Obligations	—	
4	Subordinated Debt	—	
5	Junior Subordinated Debt	—	

D. Determine the Distribution of Value

Having determined the value available to creditors and the approximate scale of creditors at each level of priority, Fitch typically assumes that this value is allocated to the various classes of creditor according to a strict legal waterfall.

- Only once the most senior creditor has received 100% recoveries would the next most senior creditor be allocated any value.
- The process continues until all available value has been distributed or all creditors have been paid in full.

In the case of groups, there can be several layers of entities with value potentially flowing up from one layer to the next (see the *Figure IX-4* below).

Once the estimated recoveries have been calculated, these are converted to Fitch's recovery bands. See the Fitch Recovery Rating Scale on the next page. These are then used to determine the RR, and then the issue rating, based on notching guidelines discussed in *Section VI*. Fitch may measure recoveries on an ultimate recovery basis, therefore it does not typically discount recoveries to reach a present value basis.

In certain markets, "soft caps" are used that state a typical maximum recovery value that Fitch may assign in certain jurisdictions that are debtor-friendly and/or have weak enforceability of creditor's rights. Given that IDRs of 'B+' or below are most common in emerging markets, "soft caps" on recoveries can potentially be significant. Where a soft cap applies, this may be applied only after the full distribution of value has taken place and may reduce the recovery rating applicable to certain instruments. For more information, see "Country-Specific Treatment of Recovery Ratings" at www.fitchratings.com.

Figure IX-4: Recovery Analysis of Groups — Illustrative Example

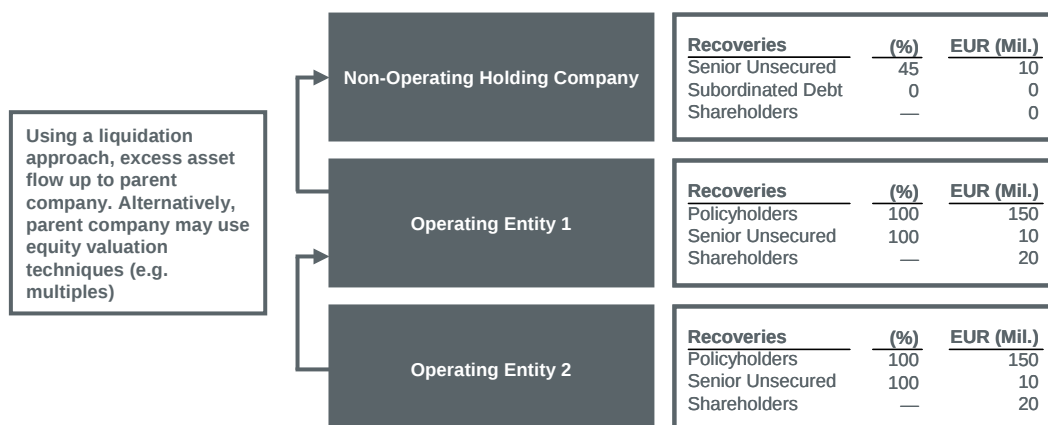


Figure IX-5: Fitch Recovery Rating Scale

The recovery scale is based on the expected relative recovery characteristics of an obligation upon curing of a default, emergence from insolvency, or following the liquidation or termination of the obligor or its associated collateral. As such, it is an ordinal scale and does not attempt to precisely predict a given level of recovery. While recovery ratings (RRs) are in relative terms, Fitch does employ the following recovery bands in assigning RRs.

Recovery Rating	Definition	Recovery Band (%)
RR1	Outstanding recovery prospects given default	91–100
RR2	Superior recovery prospects given default	71–90
RR3	Good recovery prospects given default	51–70
RR4	Average recovery prospects given default	31–50
RR5	Below-average recovery prospects given default	11–30
RR6	Poor recovery prospects given default	0–10

Note: Issue and obligation ratings will be notched up or down from the IDR based on their RR. It is generally assumed that all of the obligations of a given entity share the same default risk, as reflected in the entity's IDR.

X. Captive Insurance Companies

What Is a Captive Insurer?

For purposes of this report, a captive insurance company is defined as an insurance company established by a sponsoring organization to exclusively (or primarily) sell insurance or reinsurance to the sponsoring organization. Captives have historically been used by sponsoring organizations that desire to self-insure certain risks, but for which they are obligated to have insurance in place (such as workers' compensation insurance in the U.S.). As a licensed and regulated entity, the captive meets the legal requirement for provision of insurance. A captive will also typically cede some risks that the sponsor would view as undesirable for self-insurance, such as large losses from catastrophic events. Thus, captives typically have active reinsurance programs.

Rating Captive Insurance Companies

In this section Fitch discusses the core principles supporting the ratings of captive insurance companies. These apply to ratings of both:

- Captives owned by single (or a limited number of) industrial or other non-insurance organizations.
- Captives owned by insurance or reinsurance organizations.

In contrast, certain industry captives that have a significant number of owners/sponsors may be rated as traditional insurance companies, though any unique aspects of the ownership profile may be considered. Further, in cases where a captive is part of a legal structure where its capital is effectively ring-fenced from the owner/sponsor, Fitch may apply its insurance-linked securities rating criteria, which is noted on page 1.

All other forms of captives may be rated as discussed in this section. Captive ratings can include IFS ratings, IDRs, and/or debt issue ratings, including ratings of bank lines and letters of credit.

As discussed in more detail later, in some cases, Fitch's willingness to assign a private rating or assessment on a captive, and the methodology employed, may be influenced by the intended use of the rating/assessment.

General Ratings Concepts

The rating of any captive insurance company is based on application of the "Key Credit Factors" outlined in *Section I*, together with application of general concepts outlined in *Section V* on "Group Ratings Methodology." However, given the narrow business focus of a captive, and extraordinary linkages to a captive of its parent/sponsor(s), application of certain rating principles may differ for a captive compared with a traditional insurance company.

In particular:

- Captives' ratings may be capped at the rating of the parent/sponsor.
- Parameters for defining a captive as "Core" differ in some respects from those in *Section V* for traditional insurance groups.
- Assessments of capital adequacy may place greater emphasis on net retained risk limits relative to capital and ceded reinsurance programs.
- Capital of a captive may include material use of letters of credit (LOC), which requires additional analysis as to the implications.
- The amount of nonparent/sponsor business written may cause Fitch to rate the captive as a traditional insurer, as opposed to a captive, if significant.

Assessing a Captive's Financial Strength

The following is additional detail on the unique aspects in the ratings analysis of a captive insurance company.

Parent/Sponsor Ratings "Caps"

Generally, the rating of a parent company places a cap on the rating of a captive insurance company. For a non-insurance company parent, the IDR typically serves as the cap for the IDR of the captive. The IFS rating of the captive is also likely to be capped at the IDR of the parent, resulting in the potential compression of the captive's ratings relative to standard notching applied by Fitch for traditional insurance companies. This potential compression of ratings is

based on the expectation that insurance creditors of the captive would not recover more than senior creditors of the parent in the case of default due to the very strong linkages between a captive and its parent.

In unusual circumstances, where the sponsor is weak and the captive maintains strongly protected and high levels of capital, Fitch may choose to conduct a specific recovery analysis, which may result in the captive IFS rating set at a level above the sponsor's IDR. In these situations, a rating uplift of the captive IFS over the sponsor IDR is likely to be no greater than one rating notch (i.e. from 'BBB' to 'BBB+').

For an insurance company parent, the IFS rating of the captive is typically capped at the IFS rating of the parent.

In general, reasons for the use of the parent ratings "cap" are as follows:

- The captive would not exist without the sponsorship of the parent.
- The captive's financial flexibility, including access to capital to fund growth or replenish for losses, is derived exclusively from that of the parent.
- The captive's book of business and retention strategy, is derived from the parent and the parent's risk appetite.
- Essentially all decisions affecting the financial profile of the captive are set by, or can be heavily influenced by, the parent.
- The parent typically sets upstream dividend policy of the captive (though this may be subject to restrictions of the captive's regulator, which can vary greatly by jurisdiction).

For a captive to be rated higher than the parent, the captive would need to be capitalized at a level significantly higher than that implied by the parent's rating and other aspects of the financial profile, as implied by a stand-alone assessment, would need to be supportive of a higher rating. In addition, the concepts discussed in *Section V* on page 69 under "Rating Above the Group Assessment" would need to be in place with respect the parent-captive relationship. Fitch believes it would be extremely rare for such conditions to be met in the case of a captive.

While the parent rating typically places a cap on the captive rating in all but the most extraordinary circumstances, a captive may not achieve the parent rating unless it is considered "Core" to the parent. If not Core, the captive may be rated at the lower of the parent rating or its stand-alone assessment.

Definition of a Core Captive

Because of the unique nature of a captive's business, the parameters in defining a captive as being Core differ from those discussed in *Section V*.

- The mission and strategic goals of the captive must be intricately tied to the parent's risk management and risk financing strategy.
- The captive must serve a clear economic purposes in allowing the parent to manage risk and/or costs in a more efficient or effective manner than via use of third-party insurance or reinsurance. This can include providing consistent capacity.
- A vast majority of the captive's business is derived from that of the parent and the parent does not view the captive as a profit center or line of business. Cases of a captive providing insurance to customers of the parent would be viewed as nonparent business.
- The parent has made a reasonable financial commitment to the captive and appears supportive of its ongoing solvency and viability.

Net Retained Limits and Ceded Reinsurance

While Fitch would typically assess the capital adequacy ratios of a captive using the tools discussed in *Section I*, Fitch may also look closely at net retentions of the captive relative to capital, both on a per risk basis and in aggregate.

Since a key role of a captive is to shape risk, an appropriate balance between net retentions and purchases of ceded reinsurance (or other forms of risk mitigation) play a key role in shaping the risk profile and capital adequacy of a captive. Unusually large retentions may show lack of commitment on the part of the sponsor or a breach in overall risk management.

Because reinsurance and other risk mitigation programs can play such a critical role in the assessment of a captive, Fitch may look at such programs in more detail than it would for a traditional insurance or reinsurance company. In addition, any gaps in placement of a program may have a more pronounced impact on a captive's rating than that of a traditional insurer.

Capital "scores" for a captive that come out at levels lower than the parent's rating may cause Fitch to rate even a Core captive lower than that of the parent. Unusually high net retentions could be one area that may cause Fitch to determine the capital assessment is potentially inconsistent with assignment of the parent rating.

Capital — Letters of Credit

Fitch notes that, at times, a portion of a captive's capital may be provided in the form of a bank LOC. In some cases, the right to draw on the LOC is given to the regulator of the captive, who views the LOC as a way to obtain liquidity to fund claims in periods of stress when management or the parent may prove uncooperative. In other cases, LOCs may be arranged and/or guaranteed by a parent to limit its equity investment and to manage its cost of capital.

In either case, the rating of the bank providing the LOC may take on a heightened role in the rating of captive, especially if performance by the bank on the LOC under stress is critical to the solvency and viability of the captive. In such a case, the bank's rating may cap the rating of the captive, but would never "uplift" the rating as would a financial guaranty (unless the LOC was designed to mimic a financial guaranty).

Because the circumstances surrounding use of LOCs as a form of capital can be so varied, these may be considered by a rating committee on a case by case basis.

Nonparent/Sponsor Business

As noted, if the captive's business includes more than a very small amount of third-party business (i.e. typically under 20%), Fitch may rate the captive more as a traditional insurer and would be less likely to uplift the captive rating to that of the parent/sponsor. Fitch may consider unusual circumstances when a larger portion of third-party business may be appropriate on a case by case basis.

Captives of Insurance and Reinsurance Companies

In recent years, Fitch has noted that life insurance companies have been forming captive insurers as vehicles for capital financing transactions, such as transfer of XXX reserving risks in the U.S. In some cases, too, captives serve as defacto special-purpose vehicles (SPV) in insurance-linked securitizations (ILS).

In these cases, the captive may act as a reinsurer of a specific book of business or risk class, and then, in turn, transfer the risk to third parties, be it debt investors or banks/other counterparties.

When a captive acts as a SPV in an ILS transaction, its obligations may be rated as a structured finance obligation under Fitch criteria governing ILS entitled "Insurance-Linked Securitizations" that is listed on page 1 of this report.

In cases when the captive is not deemed a structured finance SPV, the captive rating methodology discussed in this section may apply.

Captive Private Ratings — Special Considerations

In certain cases, mainly in the case of insurance company-sponsored captives as just described, Fitch may be asked to provide a private rating or assessment on a captive by a bank or other counterparty to the captive. Often, the private rating/assessment is used by the bank or counterparty to help it judge how much capital to hold against its counterparty risks to the captive. In some cases, these private ratings or assessments may not reflect all aspects of Fitch's methodology due to the intended use of the rating or assessment.

For example, Fitch notes certain cases in which a bank LOC is used to guaranty performance of a captive for its obligations due its parent insurance company for adverse mortality experience under a XXX reserve financing. In these cases, the bank is bearing the mortality risk and risk the captive would otherwise fail. The bank may seek a private rating on the LOC facility to judge the risk of a draw for purposes of its capital requirements under bank regulations (i.e. Basel 3).

In such cases, Fitch's goal would be to provide a rating that best matches the risks specifically assumed by the bank or counterparty. In certain instances, as in the example just discussed, this may be a stand-alone rating of the captive that does not reflect uplift due to parent support. Whenever Fitch provides a rating that does not consider all of the factors outlined in this section of the criteria report, Fitch will clearly disclose these limitations in the letter that supports the private rating.

- XI. Additional Considerations**
 - A. Types of Insurance Ratings**
 - B. Information Supporting Ratings**
 - C. Limitations of Criteria**
 - D. Exceptions to Master Criteria**

A. Types of Insurance Ratings

It is important to put in context the types of ratings that can be assigned to insurance organizations. More complete details of Fitch's issuer and issue ratings are also provided in the document "Definitions of Ratings and Other Forms of Opinion." This document, as well as a description of Fitch's various rating scales and rating definitions, can be found at www.fitchratings.com.

Insurer Financial Strength Ratings

Unique to the insurance industry is the IFS rating, which is an issue rating assigned to the insurance company's policyholder obligations. This rating provides an indication of an insurer's capacity to pay its insurance claim and benefit obligations.

The IFS rating does not encompass policyholder obligations residing in separate accounts, unit-linked products, or segregated funds for which the policyholder bears investment or other risks. However, any guarantees provided to the policyholder with respect to such obligations are included in the IFS rating.

In addition to the more customary long-term IFS rating, in some cases Fitch may also assign a short-term IFS rating to policyholder obligations with a less than one year contractual duration, such as short-term funding agreements (see *Section VIII* for additional discussion of short-term rating considerations).

Issuer Default Ratings

Consistent with other Fitch corporate-finance sectors, insurance organizations are assigned IDRs. The IDR is a rating assigned to the company itself and it provides an indication of default or failure risk. The IDR typically serves as the "anchor rating" against which various issue ratings are derived via the notching exercise.

In the insurance sector, the IDR typically is only published in cases in which the entity is an actual or prospective debt issuer. Thus, IDRs are not typically published if the only other rating is the IFS rating.

IDRs can be issued on both the long-term and short-term rating scales.

Debt and Hybrid Security Ratings (Long Term and Short Term)

Consistent with other Fitch Corporate Finance sectors, within insurance issue ratings are assigned to various forms of long and short-term debt and hybrid securities. Such issue ratings are assigned to the security itself.

Debt issue ratings reflect both the default risk of the issuer as reflected in its IDR, as well as the expected recovery in the event of default (also known as loss given default). Accordingly, debt issue ratings are established by notching up or down from the IDR based on recovery assumptions. Hybrid security ratings are similarly notched up or down from the IDR based on expected recoveries, but also can consider additional risks unique to the hybrid's features, such as risk of deferral in advance of default.

Also, it should be noted that as a form of issue rating, IFS ratings are also established by notching from the IDR based on assumptions made with respect recoveries on policyholder

obligations. Such recovery assumptions are heavily influenced by assumptions made by Fitch with respect to the insurer's regulatory environment.

See *Section V* for a more detailed discussion of notching methodology.

Recovery Ratings

Consistent with other Fitch Corporate Finance sectors, Fitch may assign a specific recovery rating (RR) to a debt or hybrid security that has an issue rating of 'B+' or below. (For issue ratings above 'B+', the notching exercise uses baseline recovery assumptions, which can be found in *Section V*).

See *Section IX* for a discussion of the analysis supporting development of RRs.

RRs are subject to a soft cap reflecting the creditor-friendliness of different jurisdictions and enforceability of rights in the event of default. See the report "Country-Specific Treatment of Recovery Ratings" at www.fitchratings.com for further details.

Local and Foreign Currency Ratings

Theoretically, in emerging markets, any of the above noted credit ratings (IFS, IDR, debt issue) can be provided on a local currency (LC) or foreign currency (FC) basis. However, Fitch does not frequently publish separate LC and FC ratings for insurance companies, given that transfer and convertibility risk are rarely a defining factor to an insurer's rating. However, separate LC and FC ratings may be assigned where considered appropriate.

Further details on potential "caps" applied to FC and LC ratings are given in both *Section I-B* and Fitch's criteria *Country Ceilings*, which is available online at www.fitchratings.com.

National Ratings

In emerging markets, Fitch can also assign credit ratings (IFS, IDR, debt issue) on one of its national scales. National ratings provide a relative measure of creditworthiness for rated entities only within the country concerned. Under this rating scale, an 'AAA' Long-Term National Rating may be assigned to the lowest relative risk within that country, which will be the sovereign state in most but not all cases.

In insurance, National IFS ratings are common in Latin America and other emerging markets.

National scale ratings include a suffix denoting the country whose rating scale is being applied. Additional information on national ratings is available at www.fitchratings.com.

B. Information Supporting Ratings

Fitch's analysis and rating decisions are based on relevant information available to its analysts. The sources of this information are the issuer and the public domain. This includes relevant publicly available information on the issuer, such as audited and unaudited (e.g. interim) financial statements and regulatory filings.

The rating process also can incorporate information provided by other third-party sources. If this information is a key basis for the rating, the specific rating action will disclose the relevant source.

Most publicly traded companies would be deemed to provide sufficient and robust information to meet Fitch's minimum guidelines. In addition, in many jurisdictions, regulatory data is generally sufficient and robust and meets Fitch's minimum information guidelines.

Whenever Fitch believes information is neither sufficient nor robust, it will not assign a new rating or it will take steps to withdraw an existing rating. This determination is made solely by Fitch. This could occur in cases where Fitch uses only public information, as well as cases when Fitch also receives nonpublic information from the issuer.

Nonpublic Information

Although Fitch may receive nonpublic information from rated issuers, the extent and usefulness of such nonpublic information can vary widely from issuer to issuer, as well as over time for a given issuer. Thus, while such information can be informative, Fitch generally does not rely on nonpublic information when rating insurance organizations.

Further, the agency recognizes that publicly available information is often the only data available for investors, brokers, insurance policyholders, and other stakeholders with an interest in the creditworthiness of insurance organizations.

However, some exceptions do exist. For example, for mortgage insurers, Fitch regards detailed exposure data as important for its analysis of these organizations. These data are provided by the rated organizations, remain relevant for a period of time, and are unaudited. The period for which this exposure data remains sufficient depends on specific circumstances, but would rarely exceed 18 months from date of provision.

Evaluating Sufficiency of Information

Whenever Fitch assigns or updates a rating, it judges if information in support of the ratings analysis is sufficient. Generally, Fitch may consider the following:

- Information is considered sufficient if in the agency's view it is possible to evaluate the key risks that affect the company, as defined by these criteria.
- For a given rated entity, the agency may take into account the extent of information that is typically available for other rated companies.
- Fitch may employ reasonable estimations to help fill modest information gaps.

More specifically, the following guidelines are used:

- Typically, financial information should be available covering the last five years of operation, or from the start of business operations, if this is shorter.
- Unique circumstances may exist (e.g. involving mergers and acquisitions) that would allow Fitch to rate insurance organizations using less than five years of data.
- This is evaluated on a case by case basis.

In some cases, sector-specific criteria may set higher information requirements than those discussed in these master criteria.

Evaluating the Robustness of Information

Information is considered robust when the rating committee finds the data sufficiently informative and reliable relative to its materiality to the ratings analysis. The following also applies:

- Although Fitch places reliance on the work of auditors in its review of financial statements, Fitch may also make use of other experts where considered reliable.
- Examples include actuarial consultants, risk modeling agencies, and legal advisers, among others.
- Fitch also frequently makes use of a variety of third-party information sources as well as data provided directly by the rated organization.

Fitch applies a “reasonable investigations” standard to the information provided through these channels.

Selection and Adjustments to Information

In completing its rating analysis, Fitch often has various forms of information available that overlap. For example, Fitch may review consolidated financial statements of insurance groups, individual statements of specific insurance companies, parent-only holding company statements, and/or consolidating financial statements.

- The extent to which each of these types of financial statements are relevant varies according to circumstances.
- Not all of these types of financial statements are available from all rated entities and when that is the case, Fitch reviews the best available information.
- Different accounting rules or policies can affect an insurer's results.
- Therefore, the agency may make adjustments to reported financial information to increase comparability or to better align with Fitch's definitions.

C. Limitations of Criteria

Ratings are primarily based on a review of public information together with Fitch's judgments and forecasts. Where management interaction is forthcoming, the information derived may or may not influence the rating based on Fitch's judgment of the usefulness of such information. In certain cases, Fitch's forward-looking views related to risk exposures or forecasts may dominate a rating conclusion and such forward-looking views may be based on factors that are highly judgmental.

There are a large number of issues that can potentially have credit rating implications, particularly given the diverse nature of the global insurance industry, both by geography and product. The agency's internal analysis and external communication may be limited to those issues that Fitch considers material and most relevant to its ratings.

Unlike many nonfinancial ratings, insurance is an industry where the financial strength of the insurer is intrinsically linked to the value of the policy that is offered. Put more simply, a promise to pay claims or benefits by a very strong insurance company may be considered as being worth more than from a weaker firm and some policyholders may have minimum levels of financial strength that they consider adequate. One implication is that a slight weakening in financial strength can in some cases have a magnified effect, due to a loss of new business or the presence of explicit or implicit rating triggers. Given this characteristic of the insurance industry, the severity of ratings transition may be more pronounced for insurers relative to nonfinancial corporates, particularly in the case of downgrades around the cusp of market sensitivities.

Although financial institutions such as banks share some similar characteristics to insurers, most notably a potential vulnerability to a sudden loss of confidence, the volatility of ratings for financial institutions is moderated to some extent by an expectation of government support. Given the lower systemic importance of insurance firms, Fitch does not typically assume that government support will be forthcoming. That said, in specific instances, an expectation of government support or continued government support can provide support to ratings levels.

"Event risk" is a limitation defined as an unforeseen event that, until the event is known, is not included in the existing ratings. Event risks include management's decision to unexpectedly acquire another company, undertake a sizeable share buyback, or unexpected losses arising from an operational breach. Some ratings may already include a reasonable assumption that management's strategy is acquisitive, prone to utilizing existing financial flexibility, or has a weak operational infrastructure, but the specifics of any given event and its effect on funding, capital, and liquidity may not be known until the event is announced or consummated, at which point ratings can be ascertained.

Estimations, risks, uncertainties, and a lack of a theoretical "ideal" level of information are inevitable for any form of corporate analysis and do not in themselves constitute a limitation to the rating. However, there are cases when the agency's minimum information guidelines are met but material estimations are required in relation to key risks. Information supporting estimations may in some cases fall below that used in rating peer companies and potentially result in a greater risk of forecasting error. In such cases, and if material, Fitch will disclose this as a limitation to the rating and explain the impact of how this limitation may have affected the level of the rating.

Fitch's assessment of corporate governance and management may be limited by access to specific information provided by the issuer or contained in public documents.

Group rating methodologies were developed in a highly judgmental manner, based mainly on general observations of management behavior, regulatory, or government behavior, and the historical performance of companies within insurance groups, among other considerations. The criteria were not derived from a statistical analysis of historical data. In some cases, use of group rating criteria can introduce heightened risk of sudden, multistep downgrades related to events, such as merger, acquisition, and divestiture activities. For example, if Fitch materially raised the rating of a group member from its stand-alone level on the belief the group as a whole would provide ongoing support, but the group member is then sold, the rating of that group member could experience material ratings volatility as it migrates back to its stand-alone level.

Because Fitch's attribution of group support into ratings may be reduced as the overall financial strength of an organization declines, use of this criteria potentially introduces heightened ratings migration and variability risk as the group otherwise comes under financial pressure.

In many cases, Fitch does not maintain implied stand-alone assessments for members of a group whose rating benefits from group support. In such cases, use of this methodology could cause Fitch to withdraw the rating of the group member if a change in circumstances indicated the member should be rated on a stand-alone basis (for example, due to a divestiture) and Fitch was unable or unwilling to develop a stand-alone opinion in a timely manner. Accordingly, use of group rating criteria could lead to interruptions in Fitch's ability to maintain ratings coverage or provide an opinion to the marketplace in certain cases of organizational change.

In the context of notching and recovery methodology, the Regulatory Environment Summary table in *Section VI* shows Fitch's current understanding and interpretation of policyholder priority and form of regulation. Although Fitch uses its view for determining ratings, this information should not be relied on for any other purpose.

As far as recovery ratings (RR), the percentage recovery bands described in the RR definitions are provided for convenience only. They do not represent an expected recovery in percentage or absolute terms.

The analyses that determine RRs as well as the assumed baseline recovery prospects are heavily driven by subjective forecasts by Fitch. Information flows for companies close to default can become erratic, which may reduce Fitch's visibility on its modified recovery analysis. Legal decisions, which play a strong role in recoveries, can sharply affect recovery expectations. Out-of-court settlements are not contemplated in this methodology, other than in broad concession payments for some classes of junior-ranking bonds, in some specific scenarios. In reality, out-of-court settlements will be heavily influenced by creditor composition and local political and economic imperatives, which are subject to volatility.

Neither IDR nor RRs address creditor composition, as this is a constantly changing component that is impossible for Fitch to monitor effectively. Creditor composition nonetheless can be a major factor in the resolution of many administration, bankruptcy, insolvency, and restructuring scenarios.

Insurance ratings are subject to the limitations that are outlined in the document *Definitions of Ratings and Other Forms of Opinion* available on www.fitchratings.com.

D. Exceptions to Master Criteria

None.

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