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Rating New Company Formations

Regulatory and tax issues, as well as market dislocations and consumer demand for new and innovative products and services, continue to influence new insurance and reinsurance company formations. As a result, brokers, agents, lenders, capital market participants and corporate clients continually seek financial information about new entities as they are formed. To meet this demand, A.M. Best provides ratings on new organizations and other risk-assuming vehicles using factors outlined in this criteria procedure. This document covers all new company formations, including start-up ventures not affiliated with a currently rated organization, as well as new company formations within a currently rated group.

A.M. Best's rating process for insurance companies involves numerous quantitative and qualitative factors that are grouped into three categories: balance sheet strength, operating performance and business profile. A.M. Best's criteria procedure for rating new company formations uses the same assessments of balance sheet strength and business profile as it does for established companies receiving traditional rating assignments.

New companies are formed for many different purposes, employing a variety of business models. For example, some new companies are an extension or spin-off of an existing operation where the new entity is, in effect, inheriting an existing block of business. In other cases, the new company is a more traditional start-up venture where there is no demonstrated track record of operating performance. A.M. Best's rating approach for new companies recognizes these distinctions and allows appropriate flexibility in the assessment and evaluation process. Extensive conversations with, and an assessment of, management are central to this process in any new company rating. This assessment of management includes developing an understanding of the organization's risk management and financial management framework and expertise.

In the case of a true start-up venture, given the additional degree of uncertainty and lack of a track record, assessing the long-term sustainability of earnings and cash flows – keys to the interactive rating process – requires additional rigor in certain areas of the rating process, such as the review and analysis of business plans; the assumptions underlying the company's projections; and operational controls. In addition, to reflect the heightened level of uncertainty inherent in reviewing a newly formed entity of this nature, more stringent quantitative and qualitative metrics are applied to the rating of a new company formation. In particular, initial and prospective risk-adjusted capital levels (and related capital metrics, including financial leverage) typically will need to be well above the levels expected of a comparable existing company with a history of ongoing operations that is assigned the same rating. This level of relative conservatism applies throughout the development phase of the new company formation, even after factoring in conservative expectations for earnings and investment returns. This additional capital requirement reflects the new company formation's lack of operating history and resulting operating risk.

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Requirements for Proceeding With the Rating Assignment

For A.M. Best to proceed with an initial rating assignment, certain conditions and factors must be considered:

- A clearly defined five-year business plan that all principals are in accord with and are well qualified and capable to implement. The plan includes:

  - Policy statements on underwriting criteria, investment guidelines and risk management;
  - A thorough description of the products offered, pricing standards and the company's distribution and market strategy; and
  - Financial projections, along with the underlying quantitative and qualitative assumptions and the anticipated utilization of capital.

- Initial financing in place or expected to be executed with proceeds paid into the capital of the rated (re)insurance entity concurrently with the initial rating assignment.
- Stress-tested capitalization that conservatively supports the assigned rating throughout the business plan.
- Management's demonstration of a successful track record of operating performance relevant to the new venture's core business. Experience with organizing new insurance ventures also is factored into the process.
- Experienced management and the appropriate staff and operational infrastructure in place (or adequately addressed in a detailed implementation plan, which may include use of third party servicers) to support initial activities and meet regulatory and rating agency scrutiny.
- Management, board members, strategic investors, investment bankers, actuaries and other advisers available for discussions with A.M. Best and to provide comprehensive disclosure of requested information.
- A follow-up process in place to measure the effectiveness of the initial business plan and to monitor the company's strategic and financial development.

New Company Rating Process

The objective of any Best's Credit Rating is to provide an opinion of the rated entity's ability to meet its senior financial obligations, which for an operating insurance or reinsurance company are its ongoing insurance obligations. Best's Credit Ratings include Best's Financial Strength (FSR), Issuer Credit Rating (ICR) and Issue Credit Ratings. In assigning a credit rating to an established company, A.M. Best looks at balance sheet strength, operating performance and business profile, which is analogous to a review of a new company's initial and prospective capital, sponsorship, business plans, management and operational controls.

The rating analysis of established and new entities is both quantitative and qualitative. Evaluation of key financial ratios is integrated with a qualitative evaluation of the company's operating plans and philosophies to gain a comprehensive understanding of the company's initial standing and its prospects.

When rating members of groups, A.M. Best employs a top-down and bottom-up approach for both established and new entities within the group. Every legal entity that maintains an A.M. Best rating is reviewed on a stand-alone basis, i.e., the bottom-up analysis. The group's overall strengths and weaknesses also are analyzed, i.e., the top-down analysis. The final published rating for each legal entity within the rated group, including a newly formed subsidiary, considers the potential benefit or drag from its affiliation within a larger organization.

In A.M. Best's credit rating process, all entities, including new company formations, are viewed within the context of the particular country risks to which they are exposed. Countries are classified into one of five tiers reflecting the various economic, political and financial system risks that can affect an insurer's financial strength. Country risk is one risk factor among many in the rating process. It affects the rating but does not create a ceiling on the rating of the legal entity or group, and some elements of country risk can be managed in the same manner as other risks are managed. A.M. Best's rating system applies the same rigorous criteria to all insurers, new or established, offering a means of directly comparing insurers regardless of longevity or country of domicile.

Key Rating Factors

The analytical components of A.M. Best's interactive credit rating process for new insurers involve numerous quantitative and qualitative factors that can be grouped into the two evaluative categories of balance sheet strength and business profile. A third evaluative category of operational controls encompasses the stringent set of qualitative analysis and standards used to assess operating performance, given the lack of a measurable track record of operating performance inherent in a new company formation.

1. Balance Sheet Strength

A. Capitalization

A.M. Best's assessment of the strength and quality of a company's balance sheet is the underpinning of any credit rating. Key factors typically reviewed to assess a company's financial stability and flexibility include:

- Initial on-balance-sheet capital level, other committed capitalization and complementary financing sources.
- Stress-tested capitalization, based on the Best's Capital Adequacy Ratio (BCAR) model under various scenarios, that conservatively supports the assigned rating throughout the operating plan.
- Capital structure – equity and debt financing.
- Use of reinsurance, credit facilities and other forms of contingent capital financing.
- Quality and diversity of assets.
- Regulatory considerations.
- Investor expectations, including earnings and dividends.
- Capital generation anticipated from core business activities.
- Pricing targets.
- Expected reserving levels (conservative or aggressive).
- Investment strategy for reserves and capital. The investment strategy should be consistent with the mix of business, financial plans, liquidity needs and capitalization. Since investment management is important to preserving capital, A.M. Best will review the quality and diversification of assets and the reputation and experience of the investment managers.
- Expertise and processes for managing assets, liabilities and other drivers of enterprise risk individually, as well as the interrelationships among risks. In reviewing initial and prospective capitalization and operating leverage, A.M. Best begins with the capital requirements of the relevant regulatory authorities. This is followed by a rigorous capital analysis using BCAR to assess the capital that is necessary to support the new venture's operations over a period of time and that is appropriate for the types of business written.

Determining Risk-Adjusted Capital Requirements

The new company should demonstrate that it can support the execution of its business plan while maintaining risk-adjusted capital adequacy at levels well above what typically would be expected of a more mature company at the assigned rating level throughout the period of the operating plan. The amount of additional capital needed will reflect the risk profile of the business. A higher level of capitalization might be required if the business is subject, for instance, to low-occurrence but high-severity events, or operates in a line of business that typically generates an initial drain on capital due to the slow emergence of profits. A.M. Best also will stress test the pace at which the company expects to utilize its capital. At all rating levels, the capital required will reflect the greater risks inherent in a start-up venture compared with an established company's continuing operations.

As of the initial rating date, A.M. Best expects the new company formation to have adequate on-balance-sheet capital to support appropriate risk-adjusted capital adequacy levels, relative to the rating assigned, considering the company's projected business activities throughout the five years of the business plan. The BCAR calculated for the new company formation and utilized within the rating process will capture the expected level of business writings, investment and asset risk, general business risk and other elements of risk inherent in the new company's operations over the five-year period. It is important to note, however, as with any interactive credit rating, that capitalization and the BCAR results are not the sole determining factors in the assignment of a rating. In determining the published initial credit rating, and the corresponding initial on-balance-sheet capital requirement for a specific new company formation, A.M. Best will consider the type of business to be written; expected growth pattern (including whether the plan calls for organic growth or growth through block acquisition); and availability of additional financial support, as well as risks related to the capital structure of the parent or investor providing additional financial support.

A.M. Best's assessment of the strength and quality of a company's balance sheet also incorporates an evaluation of the company's financial stability and flexibility. The level, quality and permanence of capital, including potential distributions of initial investor capital, are evaluated, taking into consideration the company's appetite for risk, the structure of its assets, its dependence on reinsurance and its liquidity needs. If the organization's capital structure includes some form of debt, contingent or hybrid capital, additional analysis will be performed in accordance with A.M. Best's rating methodology – possibly culminating in a public rating on certain debt instruments. Please note, as mentioned earlier, that to reflect the heightened level of uncertainty inherent in reviewing a newly formed entity, higher quantitative and qualitative standards are applied to the rating of a new company formation.

B. Sponsorship and Investors

A new company's sponsors and/or strategic investors can significantly affect its success in meeting its objectives. Their experience and commitment to the company over the near and long term, including any potential exit strategies, are key considerations in the rating process.

A.M. Best considers the competitive advantages that a sponsor might provide to a new company, as well as the new company's expected benefits to the sponsor's core business, as an indication of the sponsor's likely long-term commitment to the new company. It is also important to understand the return investors expect and the reasonableness of these expectations relative to the new company's business plan and existing market conditions. For example, if the sponsor is a rated organization that provides turnkey capability to a new company that, in turn, supports the sponsor's core business, A.M. Best might view that favorably in the rating process.

If the sponsor also provides financial guarantees or reinsurance support that is acceptable to A.M. Best, this too might enhance the rating assessment. A more conservative rating approach is required of situations where investors are looking to make a quick return because of prevailing, favorable market conditions, as short-term adversity could lead them to withdraw support. In these situations, regulatory controls on paid-up capital, and the likely underlying attractiveness of the operation to future capital providers, are especially important. Expected dividend policy is a key part of the initial rating analysis, and any subsequent increase in the scale or early introduction of dividends compared with the initial plan will be a negative factor in the rating.

The strength of the sponsor/new company relationship is evaluated by considering a variety of factors, such as:

- Type of sponsor or investor – strategic/financial support.
- Level of financial and operational commitment.

- Investors' return expectations (reasonableness, timeliness, exit strategies) and level of management interaction (active or passive investor).
- Linkage or synergies with an existing insurance or noninsurance organization, such as a mutually beneficial long-term relationship with the sponsor.
- Strategic/operational support (distribution or markets).
- Additional financial support (capital contributions, financial guarantees and reinsurance agreements).
- Financial flexibility and strength of the sponsor or investor.

2. Business Profile

A. Business Plan and Strategy

A clearly defined business plan is essential. The success of the company depends on management's ability to effectively implement the business plan while remaining responsive to changing conditions. The business plan and financial targets serve as a benchmark against which A.M. Best will measure the company's success in the first few years. Some of the areas A.M. Best explores include:

- Targeted lines of business that are consistent with the expertise and track record of management and, if relevant, the company's strategic investors or its parent company;
- Pricing targets and financial plans that are compatible with expected returns and capital protection and generation; and
- Whether the new company is set up to serve an appropriate business purpose or as a means to reduce taxable obligations.

Key information typically reviewed in A.M. Best's evaluation includes:

- Well-defined five-year business plan;
- Targeted classes of business;
- Competitive environment and the characteristics that will differentiate the company;
- Distribution/client relationships;
- Pricing methodologies and monitoring practices;
- Return expectations vs. market realities;
- Defined risk management and underwriting policy statements;
- Investment strategies, both long term and short term; and
- Projected financial results, including balance sheet, income statement, cash flows and capital obligations.

B. Management

A.M. Best looks at the depth of the senior management in terms of its track record in critical functional areas, such as underwriting and claims management; financial, investment and risk management; information technology; and marketing, sales and distribution. A.M. Best's review of management considers:

- Experience in managing other operations through start-up and changing business conditions.
- Financial and operational risk tolerance.
- Consistency of the business plan and investment strategy with those of sponsors or investors and with market realities.
- Alignment of incentive compensation plans, employment contracts and management investments with the attainment of the company's long-term financial and strategic goals, shareholder value and policyholder security.
- Ability of management to attract key personnel, establish sound business practices, and

develop formal monitoring processes and the appropriate infrastructure and operating controls to support operations.
- Succession plans, especially if the founding management is in place only to develop the initial business plan.

3. Operational Controls

Operational controls are important indicators of management's ability and commitment to the quality and longevity of a new company. These controls should be linked to the monitoring and fulfillment of the business plan. Operational controls also are the means by which the new company's growth is managed and provide a large measure of risk management. As part of the review of operational controls, A.M. Best considers:

- Whether statements on investment, risk management, underwriting and accounting policy are defined clearly, and whether those statements are consistent with the company's business plan, capitalization and management's appetite for risk.
- The company's valuation methodology for establishing reserves.
- Its monitoring of catastrophic exposures and modeling techniques used.
- Its process for monitoring of pricing and underwriting decisions, including the frequency and depth of the review process.
- Its monitoring and reporting of investment risk exposures (including fluctuations in interest rates, equity markets, inflation and exchange rates) generated by both the company's asset holdings and its liability structure, as well as the exposure created by the interrelationship of those risks.
- The controls to monitor the new company's distribution relationships, due diligence, productivity, revenue tracking and expense controls.

A.M. Best's Monitoring Process

Maintaining a rating on a new company also requires significant ongoing surveillance by A.M. Best, over and above that already required when rating established operations. In assigning an initial rating, A.M. Best and the company agree on a formal plan to monitor the company's strategic and financial development. This plan usually entails quarterly reviews with management and other principals on the company's progress toward its stated objectives. Any changes in strategy are discussed and considered in the ongoing rating evaluation.

As with the initial rating, A.M. Best requires detailed disclosure in monitoring the rating. Companies are asked to provide all information necessary for continuing analysis. This generally includes annual and quarterly statements, reviews of risk management, revisions of business plans and documentation on insurance written.

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METHODOLOGY

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Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Rating Disclosure: Use and Limitations
A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance and business profile or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services Inc., (AMBRS) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AMBRS.

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