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Best's Methodology and Criteria

Rating New Company Formations



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Rating New Company Formations

Outline

- A. Market Overview
- B. Balance Sheet Strength
- C. Operating Performance
- D. Business Profile
- E. Enterprise Risk Management (ERM)
- F. Rating Lift/Drag

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

A. Market Overview

New companies are formed for many different purposes, using a variety of business models. For example, in some cases, a newly formed company is an extension or spin-off of an existing operation, whereby the new company is in effect inheriting an existing block of business. In other cases, the new company is a more traditional start-up venture lacking an operating performance history. This criteria procedure covers all rating units based on new company formations, including start-up ventures not affiliated with a currently rated organization, as well as new companies formed within a currently rated group.

A new company's sponsors and/or strategic investors can significantly affect its success in meeting its objectives. The experience and commitment of a sponsor or investor to the company over the near and long term, including any potential exit strategies, are key considerations in the rating process. AM Best's rating approach for new companies recognizes these distinctions and allows appropriate flexibility in the assessment and evaluation.

Requirements for an Initial Rating Assignment

For AM Best to proceed with an initial rating assignment, certain conditions and factors must be present:

1. A clearly defined five-year business plan that all principals are in accord with and are well qualified and capable to implement, and that includes the following:
 - 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
 - Financial projections, along with the underlying quantitative and qualitative assumptions and the anticipated use of capital
2. Initial financing in place or expected to be paid into the capital of the rated (re)insurance entity concurrently with the initial rating assignment

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3. Stress-tested capitalization that conservatively supports the business plan
4. 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
5. Management and board members, along with as applicable strategic investors, investment bankers, actuaries and other advisers available for discussions with AM Best, to provide comprehensive disclosure of requested information

New Company Rating Process

AM Best's rating process applies the same rigorous criteria to all insurers, new or established, which allows for a direct comparison of insurers regardless of longevity or country of domicile. To rate new company formations, AM Best uses the same assessment building blocks as it does for established companies (**Exhibit A.1**). This criteria procedure focuses on the areas that receive particular emphasis in the process of rating a new company formation, such as the review and analysis of (1) business plans, (2) the assumptions underlying the new company's projections, and (3) its operational controls. In addition, more stringent quantitative and qualitative metrics may be applied, to reflect the heightened level of uncertainty inherent in reviewing a new company.

Exhibit A.1: AM Best's Rating Process

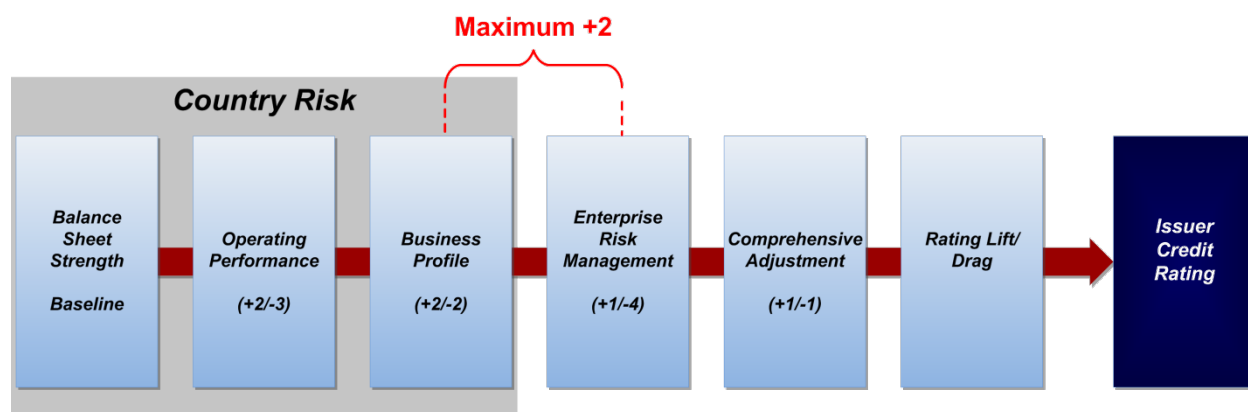


Exhibit A.2 details the possible assessments for each building block as described in the BCRM. However, owing to the unique considerations associated with rating a new company, the range of assessments available for it may be more limited than those listed in the exhibit.

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Exhibit A.2: BCRM Building Block Assessments

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

Rating Unit Eligibility

Should a new company be added to an established rating unit and given its affiliation code, the rating analysis would follow the assessment process detailed in the BCRM.

B. Balance Sheet Strength

Because of heightened uncertainty about future balance sheet conditions, companies with less than five years’ operating experience or limited business plan execution are generally precluded from receiving a balance sheet strength assessment of “Strongest.”

Quantitative Analysis

AM Best’s assessment of the strength and quality of a company’s balance sheet is the foundation of any credit rating. A new company’s initial and prospective net required capital levels (and related capital metrics, including financial leverage) typically will need to be more conservative than what is expected of a comparable company that has a history of ongoing operations and that is assigned the same rating. This level of conservatism applies throughout the development phase of the new company formation, even after factoring in conservative expectations for earnings and investment returns. The additional capital requirement reflects the lack of operating history and the operating risk associated with executing a new business plan. The new company should demonstrate that it can (1) effectively execute its business plan throughout the plan period typically, five years and (2) maintain available capital at levels well above what typically would be expected of a more mature company at the assigned confidence level.

The amount of additional capital needed will reflect the business’s risk profile. A higher level of capital might be required if the business is subject to low-occurrence but high-severity events, for instance, or operates in a line of business that typically creates an initial drain on capital owing to the slow emergence of profits. AM Best will also assess the pace at which the company expects to use its capital. Generally, initial capitalization of the five year plan is expected to be funded upon the assignment of the rating. However, there can be circumstances that allow alternative capital funding timing. The capital required will reflect the greater risks inherent in a start-up venture compared with an established company’s continuing operations, at all confidence levels.

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As of the initial rating date, AM Best expects the new company formation to have on-balance-sheet capital to support the appropriate net required capital adequacy levels, in light of the company's projected business activities. In determining the initial on-balance-sheet capital requirement for a specific new company formation, AM Best will consider the type of business to be written; the expected growth pattern (including whether the plan calls for organic growth or growth through block acquisition); the availability of additional financial support; and the risks related to the capital structure of the new company formation and the parent or investor providing additional financial support. The BCAR calculated for the new company formation and used in the rating process for initial capitalization will generally be supplemented with a BCAR that 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 span of the business plan (typically a five-year period), such as the increased underwriting risk and volatility of technical results associated with a lack of experience in new markets or new lines of business. Additional capital requirements represent a cushion for companies whose growth exceeds expectations, given that a new company's ability to generate organic capital is often limited in the early stages of development. BCAR-based stress tests on capitalization that conservatively support the targeted confidence levels throughout the operating plan in a number of scenarios will be run, depending on the risk profile of the rating unit. However, as with any credit rating, capitalization and the BCAR results are not the sole determining factors in the assignment of a rating.

Other Qualitative Factors

AM 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. For new company formations, the balance sheet strength evaluation places particular emphasis on the following:

- The initial amount of on-balance-sheet capital, other committed capital, and additional financing resources
- The quality of capital, including the use of reinsurance, credit facilities, and other forms of contingent capital financing
- Investor expectations for dividends
- The capital generation anticipated from core business activities
- Expected reserving levels (conservative or aggressive)
- An investment strategy for reserves and capital for both the short and long terms. 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, AM Best will review the quality and diversification of assets and the reputation and experience of the investment managers.

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Holding Company

For new companies, the impact of a newly formed holding company is unlikely to be positive, given the lack of demonstrated financial flexibility. For established holding companies, the analysis follows the process outlined in the BCRM.

C. Operating Performance

AM Best views operating performance as a leading indicator of future balance sheet strength and long-term financial stability. Operational controls encompass the stringent set of qualitative analysis and standards used to assess operating performance, given the lack of a history of operating performance inherent in a new company formation. When assessing operating performance, analysts will review:

- Management’s demonstration of a successful operating performance relevant to the new venture’s core business
- Investor expectations of earnings
- Return expectations vs. market realities
- Projected financial results, including balance sheet, income statement, cash flows, and capital obligations
- Pricing targets and financial plans that are compatible with expected returns and capital generation and protection

Given the lack of track record for true start-ups (greenfield operations), a newly formed company is unlikely to receive an assessment higher than “Adequate” for operating performance, and may be assigned a lower assessment owing to its start-up nature and the expected volatility of the business written. Operating performance is often strained at the outset by pressure from high fixed costs, potentially resulting in operating losses. The ability to build a supportive base of business is frequently a challenge. The performance of acquired blocks of business with operating track records may be viewed either positively or negatively in the assessment.

D. Business Profile

Business Plan and Strategy

A clearly defined business plan is essential. A company’s success depends on management’s ability to effectively implement the business plan while remaining responsive to changing conditions. Experience with organizing new insurance ventures also is factored into the process. The business plan and financial targets serve as benchmarks against which AM Best will measure a company’s success in the first few years. Areas AM Best explores include the following:

- 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

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- Whether the new company is set up with a sustainable, long-term business plan or whether its creation is driven by other factors, such as compulsory business or a tax-driven strategy

Key information typically reviewed in AM Best’s evaluation includes the following:

- A well-defined five-year business plan
- Targeted classes of business
- Regulatory considerations
- Competitive environment and the characteristics that will differentiate the company
- Distribution/client relationships
- Pricing methodologies and monitoring practices

Given the lack of brand awareness, a newly formed company is unlikely to receive an assessment higher than “Neutral” for its business profile, and may be viewed even more negatively until it has gained market acceptance. Companies that are part of larger, well-recognized groups may receive some benefit in the business profile assessment.

Typical observations of the sub-assessments within business profile follow.

Market Position

Market position is not meaningful in the initial year or so of operation, as a new company’s market share may be close to or equal to zero at the time of the rating assignment. As the company executes its business plan, its market share may increase to meaningful levels for evaluation. However, rapid increases in market share are likely to be viewed as “Negative.”

Likely Assessment: Neutral to Negative

Degree of Competition

The analyst will review the barriers to entry for the market(s) that the new company is looking to enter. True start-ups are likely to be viewed as “Negative” in this category, because they tend to underestimate the level of competition, unless it is a new market opportunity with very few established competitors.

Likely Assessment: Neutral to Negative

Distribution Channels

Initially, a new company’s distribution channels will have a limited impact on the evaluation. The importance of distributions channels will increase over the life of the business plan, and the analyst will evaluate whether distribution is productive, produces high quality business, and is persistent. Concentration in distribution channels can have a negative impact on the assessment.

Likely Assessment: Neutral to Negative

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Pricing Sophistication and Data Quality

New companies may have access to more sophisticated technology and be unburdened by less robust legacy systems. In this case, a “Positive” view may be possible for this component. A “Negative” view could also be possible depending on the company’s data quality and whether it uses third-party data for pricing.

Likely Assessment: Positive to Negative

Management Quality

The experience and depth of management are important determinants in the ultimate success of a new operation. A strong record of success both with start-ups and in the chosen line(s) of business could result in a “Positive” view for this component; however, the evaluation should account for the difficulties associated with blending multiple management styles.

Likely Assessment: Positive to Negative

Product/Geographic Concentration

The evaluation will take into account the plan and scope of the new company’s operations. Similarly to existing companies, single country/state or limited geographic/product focus is likely to result in a “Negative” view for this component.

Likely Assessment: Neutral to Negative

Product Risk

The risk associated with each of the individual products the new company offers can also have a strong impact on business profile.

Likely Assessment: Positive to Negative

Regulatory, Event, Market, and Country Risks

The analyst will evaluate any unique regulatory, event, market, or country risk hurdles the new company may face.

Likely Assessment: Neutral to Negative

E. Enterprise Risk Management (ERM)

Management

AM Best looks at the depth of 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. Extensive conversations with, and an assessment of, management are central to this process for any new company rating. An assessment of management entails developing an understanding of the organization’s risk management framework and financial management expertise. Given the limited period of development, the ERM assessment is likely to fall between “Appropriate” and “Weak.” AM Best’s evaluation of risk management takes

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into account execution risk, including the failure to build out operational capabilities on a timely basis; failure of key underwriting controls resulting in losses; and failure to retain key employees.

AM Best's review of enterprise risk management considers:

- Experience managing other operations through start-up and changing business conditions
- Financial and operational risk tolerance
- Defined risk management and underwriting policy statements
- The consistency of the business plan and investment strategy, whether they are in line with those of sponsors or investors and with market realities
- Alignment of incentive compensation plans, employment contracts, and management investments with the company's long-term financial and strategic goals, shareholder value, and policyholder security
- Management's ability 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
- Expertise and processes with regard to managing assets, liabilities, and other drivers of enterprise risk individually, as well as the interrelationships among risks

Operational Controls

Operational controls are important indicators of management's ability and commitment to the quality and longevity of a new company, and should be linked to the monitoring and fulfillment of the business plan. Operational controls also are the means by which a new company manages its growth and constitute a large part of enterprise risk management. In its review of operational controls, AM Best considers the following:

- 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
- The company's monitoring of catastrophic exposures and the modeling techniques used
- The company's process for monitoring pricing and underwriting decisions, as well as the frequency and depth of the review process
- The company's monitoring and reporting of investment risk exposures (including fluctuations in interest rates, equity markets, inflation and exchange rates) generated by both its asset holdings and its liability structure, as well as the exposure created by the interrelationship between those risks

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- The controls to monitor the new company's distribution relationships, due diligence, productivity, revenue tracking, and expenses

F. Rating Lift/Drag

AM Best considers the competitive advantages that a lead rating unit or non-insurance parent (if the new company is the lead rating unit), might provide to a new company, as well as how the new company is expected to benefit the core business, an indication of the long-term commitment to the new company. Also important is understanding the return investors expect and the reasonableness of those expectations relative to the new company's business plan and existing market conditions. For example, with regard to rating lift/drag, AM Best might favorably view a rated organization that provides turnkey capability to a new company that, in turn, supports its core business. Any inherent risks associated with a start-up company may be somewhat mitigated if the company is a part of a recognized insurance brand with deep operational resources. The start-up may also be able to access the organization's existing client base, investment expertise, risk management, and control systems. Any financial guarantees or reinsurance support that AM Best considers acceptable could factor favorably into the assessment of rating lift/drag.

A more conservative rating approach is required when investors are looking to make a quick return because of favorable market conditions, given that short-term adversity could lead to the withdrawal of 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. The expected dividend policy is a key part of the initial rating analysis, and any subsequent increase in the scale or early introduction of dividends versus the initial plan will be a negative factor in the rating.

The strength of the relationship is evaluated by considering a variety of factors, such as the following:

- The link or synergies with an existing insurance or noninsurance organization, such as a mutually beneficial long-term relationship with the sponsor
- Strategic/operational support
- Additional financial support (i.e., capital contributions, financial guarantees and reinsurance agreements)

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