

## Rating New Company Formations

In recent years, regulatory and tax issues, as well as market dislocations, have contributed to the formation of new insurance and reinsurance companies. As a result, growing numbers of brokers, agents, lenders, capital market participants and corporate clients are seeking financial information about these new entities. To meet this demand, A.M. Best Co. provides ratings on these new organizations and other risk-assuming vehicles using methodology outlined in this report.

A.M. Best's interactive 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 methodology 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.

Since, however, these new companies have yet to demonstrate a track record of operating performance, A.M. Best applies an additional set of quantitative and qualitative standards to the initial rating to reflect the extra uncertainty. In particular, initial and prospective risk-adjusted capital levels typically will need to be well above the assigned initial rating level throughout the development phase of the company, even after factoring in conservative earnings and investments returns. Extensive conversations with, and an assessment of, management are central to this process.

These criteria might apply partially or not at all to some newly organized, nontraditional insurance entities, such as virtual companies and special purpose vehicles.

### Criteria for Proceeding with the Rating Assignment

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

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*Questions regarding A.M. Best's methodology for rating new insurance company formations can be directed to Matthew Mosher, senior vice president in the property/casualty division.*

- Initial financing in place or expected to be executed concurrently with the initial rating assignment.

- Stress-tested capitalization, which 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.

- A clearly defined, three-to-five-year business plan that all principals are in accord with and are well qualified and capable of implementing. 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.

- Experienced management and the appropriate staff and operational infrastructure in place (or adequately provided by third parties) 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 Best's Financial Strength Rating (FSR) is to provide an opinion as to an insurer's ability to meet its obligations to policyholders. In assigning a FSR 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 future prospects.

As with the traditional Best's FSR process, start-up entities are viewed within the context of the particular country risks to which they are exposed. Under these circumstances, A.M. Best utilizes its Country Risk Methodology, whereby countries are classified into one of five tiers reflecting the various economic and political risks that can affect an insurer's financial strength. The country risk tier is one factor, among many, in the rating process, and while it affects the rating, it is not necessarily a ceiling on the rating.

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. However, because a new company rating opinion must consider a greater degree of uncertainty, A.M. Best is conservative in its initial rating assignment.

## Key Rating Factors

The analytical components of A.M. Best's interactive 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. Since new companies lack a measurable track record of operating performance, A.M. Best applies a stringent set of qualitative (due diligence) standards to the initial rating. These are grouped into a third evaluative category of operational controls.

### 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 FSR. In reviewing initial and prospective capitalization and leverage, A.M. Best begins with the capital requirements of the relevant regulatory authorities.

This is followed by a rigorous capital analysis using Best's Capital Adequacy Ratio (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.

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 the assigned rating level for at least three to five years. The degree 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. A.M. Best also will stress test the pace at which the company expects to utilize its capital. The capital required at all rating levels will reflect the greater risks inherent in a start-up venture compared with an established company's continuing operations.

The process includes an evaluation of the company's financial stability and flexibility.

# A.M. Best Co.

## Methodology

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Best's Ratings reflect the A.M. Best Company's opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. These ratings are not a warranty of an insurer's current or future ability to meet its contractual obligations, nor are they a recommendation to buy, sell or hold any security. Further, any and all information herein is provided "as is," without warranty of any kind, expressed or implied. A.M. Best Company receives compensation for its interactive financial strength ratings, from the insurance companies it rates. In compliance with the Securities Act of 1933, A.M. Best also discloses that it receives rating fees from most issuers of the debt securities it rates. Those fees fall within a range of \$5,000 to \$480,000.

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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. Key factors reviewed include:

- Initial capital commitment.
- Stress-tested capitalization based on the BCAR model under various scenarios, which conservatively support 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.
- Targeted risk-adjusted capital under the BCAR model.
- 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 forms of enterprise risk.

### ***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 might give credit in the rating where the sponsor is a rated organization that provides turnkey capability to a new company that, in turn, supports the sponsor's core business.

If the sponsor also provides financial guarantees or reinsurance support that is

acceptable to A.M. Best, this too might enhance the rating level. 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.

A.M. Best also considers the competitive advantages that a sponsor might provide to a new company. Also assessed are the new company's expected benefits to the sponsor's core business, as this gives 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.

The strength of the sponsor/new company relationship is evaluated through the following factors:

- Type of sponsor or investor—strategic/financial;
- Level of financial and operational commitment;
- Investors' return expectations (reasonableness, timeliness, exit strategies);
- 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, markets); and
- Additional financial support (capital contributions, financial guarantees and reinsurance agreements).

In certain circumstances, A.M. Best might find it appropriate to use its Insurance Group Rating Methodology for certain companies that are considered core or strategically important to their sponsors that are rated interactively.

## **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 success of the company 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 factors in A.M. Best's evaluation include:

- Well-defined three-to-five-year business plan;
- Target classes of business;
- Competitive environment and the characteristics that will differentiate the company;
- Distribution 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. As part of the review of management, A.M. Best examines:

- 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 that of sponsors or investors and 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 its 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 examines:

- 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.
- 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 informa-

tion necessary for continuing analysis. This generally includes annual and quarterly statements, reviews of risk management, revisions of business plans and documentation on insurance written.

**Guides to Best's Financial Strength and Debt Ratings are available at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology).**



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