

Frequently Asked Questions: Rating Start-Up Reinsurers

There have been many questions, both direct and indirect, regarding A.M. Best's rating of start-up reinsurance companies in late 2005 and 2006. In an effort to answer some of these questions, we have prepared the following FAQ.

The FAQ should be used in conjunction with other A.M. Best sources of information on start-ups. New company formations have been discussed in various venues, including A.M. Best press releases and methodologies; the Dec. 12, 2005 conference call; conference panels and presentations at numerous industry events; and during A.M. Best's May 2006 Bermuda Reinsurance Briefing. Additionally, teams of A.M. Best analysts have had numerous conversations about this issue with interested parties throughout the industry.

1. Why did AMB rate these start-ups?

A.M. Best believes the practice of rating start-ups is a positive contribution to the overall health of the insurance industry. While A.M. Best recognizes there is a higher degree of uncertainty and greater execution risk with any start-up enterprise, to help mitigate these concerns, newly formed companies are required to maintain very conservative levels of risk-adjusted capitalization during the start-up phase, which generally is considered to be at least five years. In addition, as a prerequisite, the expertise of its management and operating personnel, as well as the development of infrastructure or infrastructure support for operations, must be demonstrated in order to obtain a Best's Rating. A review of planned aggregate exposures to catastrophe losses and probable maximum losses through the due-diligence process engages companies in risk-management issues long before they manifest themselves in balance-sheet problems.

A. M. Best has a well-established follow-up process to evaluate and measure the effectiveness of the initial business plan and to moni-

tor the company's strategic and financial development. Should there be any material negative deviation from the original business plan, the conservative level of risk-adjusted capitalization provides for a timely adjustment to a stated rating.

2. What conditions must be met for A.M. Best to proceed with an initial rating assignment of a start-up company?

- A clearly defined, five-year business plan must be finalized, including support of all principals and evidence that management is well qualified, committed and capable of implementing the plan.

- Management, board members, strategic investors, investment bankers, actuaries and other advisers must be available for discussions with A.M. Best and to provide comprehensive disclosure of requested information.

- Management must demonstrate 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. The operating performance at the companies where members of the management team previously worked will be taken into consideration. If the performance of those companies was weak during their tenure, the projected earnings for the new venture will be reduced to reflect the potential that projected operating performance might not go as planned.

- Experienced management and the appropriate staff and operational infrastructure must be in place, or adequately provided by third parties, to support initial activities and meet regulatory and rating agency scrutiny.

- Capitalization as delineated in the business plan must conservatively support the assigned rating throughout the start-up phase of operations, which generally is deemed to be no less than five years. The five-year business plan as submitted to A. M. Best must withstand stress tests for profitability shortfalls and shock losses.

- Initial financing must be completed prior to or concurrent with the initial rating assignment.

For more information refer to the A.M.

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Best Methodology, *Rating New Company Formations* (March 8, 2004).

3. Don't Best ratings require a minimum of 5 years of experience? When did A.M. Best begin rating start-up companies?

For decades, a five-year seasoning of representative operating experience for a company was required to earn a Best's Rating. A.M. Best's goal is and always has been to offer an independent, third-party opinion of the financial strength of an insurer/reinsurer. A.M. Best's value to the public is in stating these opinions on entities that qualify. All ratings, both new and established, contain a significant amount of prospective analysis. In all rating analyses, a company business plan is a material part of this prospective analysis. Accordingly, starting more than 10 years ago, companies have not been required to wait five years before requesting a rating opinion.

4. From a rating perspective, what are the major differences between the "Class of 2001" and the "Class of 2005"?

The primary differences between the classes are the sources of capital during the initial start-up phase. Initial capital for the Class of 2001 was sourced primarily from the broker market, while the Class of 2005 source of capital tended to be private-equity firms and hedge funds. Overall, capital raised per company for the Class of 2005 generally was less than for the Class of 2001, as the business plans were not as broad. Following Sept. 11, the Class of 2001 found business opportunities in several underwriting lines, while the Class of 2005 is focused primarily on property catastrophe. Management profiles also differed, as the Class of 2001 tended to be led by senior executives with years of experience heading large insurance/reinsurance companies. Management profiles for the 2005 class tend to be broader, with a mix of experience leading both companies and business segments for large firms.

Additionally, the positive market momentum found in 2001 was much narrower in 2005 and warranted more conservative capital levels to protect against the greater market risk, in addition to the capital required to protect against the operational risk inherent in their start-up status.

5. These new reinsurers have no track record; how can you rate them? How can they have ratings that are comparable to more established companies?

Given the extremely poor reserve development from 1997-2001, there is much to be said for a clean balance sheet because of the lack

of legacy issues. While the management teams are new, they all bring significant track records, which they have had to justify to A.M. Best's analysts. Modeling advances following the 2005 catastrophe season have provided an added layer of conservatism to business plans. Last and probably most important, the Class of 2005 ratings are based on the companies maintaining an extremely conservative level of capitalization, much more so than for the Class of 2001, to act as a buffer against the extreme degree of execution risk that exists for any new enterprise.

6. Other rating agencies have said that start-up companies cannot be rated "A-". Why is A.M. Best comfortable assigning an "A-" rating to a start-up company?

A.M. Best Co.

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The Insurance Information Source

A.M. Best's evaluation is conducted within our published criteria, including our start-up methodology. The prospective view of the company's business plan is considered in conjunction with A.M. Best's review of the company's current and planned infrastructure and the historical track record of the overall management team. Additionally, capital requirements are raised to reflect the additional execution risk a start-up company will face. It is A.M. Best's belief that in a prospective review, the company rating can be supported by additional capital to minimize the impact of potential risks. A.M. Best does not believe in creating an arbitrary line in the rating scale that a company cannot overcome, even before any analysis is conducted.

7. Did all reinsurance start-ups that approached A.M. Best achieve the requested rating level?

No. All companies that formally engaged with A.M. Best received a rating, but not necessarily the rating sought. When a company receives an initial rating, it has the right to decline, and the rating decision remains confidential. Other groups have considered start-ups, but after they read A.M. Best's methodology and requirements, these efforts

proved to be short lived, and A.M. Best was not formally engaged.

8. What may have prevented a rating?

Indefensible business plans, nonsupportive capital, lack of management depth and inadequate management controls all are issues that have prevented start-ups from achieving their desired rating levels.

9. If a start-up rating is downgraded in the first five years, wasn't the rating wrong in the first place?

No. The initial ratings are based on the information presented at the time of the analysis. As is the case with any rating downgrade, events occur, or the company changes its business practices from the original business plan in a manner that no longer supports the current rating. This change does lower the financial strength of the company, but it does not mean that the company has failed or the original analysis was incorrect.

Unfortunately, the impact of a downgrade on an "A-" rated company can limit the company's ability to write business, particularly if it is a new company; however, it does not mean that the company cannot meet its ongoing financial obligations.



The Insurance Information Source

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