Rating Methodology

2 June 2023

Request for Comment: Insurers

Industry-specific rating methodology

CCXAP publishes a Request for Comment (RFC) on the proposed rating methodology for insurers

Summary

China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") proposes to introduce a new methodology for assessing the credit quality of insurance companies. The proposed methodology broadly applies to insurers globally, including insurers in life and health, property and casualty, trade credit, as well as reinsurers.

An insurer is typically a non-bank financial institution that engages in direct or indirect insurance business and bears underwriting risks. Insurers, in general, provide insurance services to their customers and makes a profit through net premiums earned and returns from investments. Insurers mostly share a basket of common risk factors but different types of insurers may have some special characteristics that should be considered separately. For example, property and casualty (P&C) insurers exhibit much higher loss frequency and severity behaviors than life insurers. In response to the difference in risk characteristics among insurers, we will include adjustments for each rating factor in our methodology.

Our general approach for assessing an insurer's credit risk includes a baseline credit assessment ("BCA") and external support analysis. BCA primarily reflects an insurer's credit risk before the consideration of the external support, which is made up of (1) macro environment, (2) institutional profile, and (3) other adjustment factors. After that, we will incorporate the potential support from shareholders or the government to reach a final rating.

This proposed methodology introduces the key determinants for rating insurers and explains our approach to assessing each key rating determinant in detail. It also includes a discussion about the availability of external support as well as assumptions and limitation underlying the rating methodology.

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Impact on Ratings

CCXAP does not have any existing rated entities that match the scope of application of the rating methodology for insurers, so the adoption of this methodology is not expected to result in any rating changes.

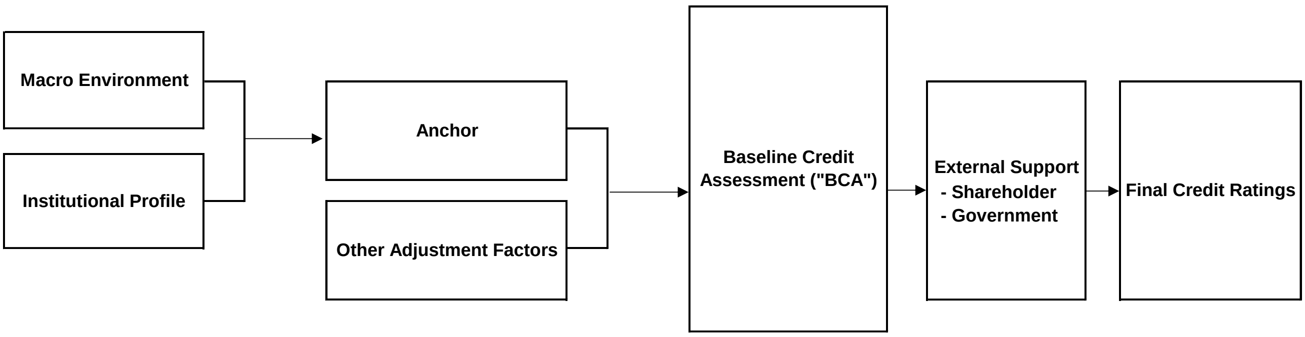
How to Submit Comments

In this request for comment, CCXAP invites interested market participants to submit written comments on the proposed rating methodology by 3 July 2023 on the Request for Comment page or via email at info@ccxap.com. CCXAP will review and take all received comments into account before publishing the methodology.

Introduction of Rating Methodology

Our general approach for assessing an insurer's credit risk follows four pillar evaluations as shown in Exhibit 1, including considerations of macro environment, institutional profile, other adjustment factors and external support. We combine an insurer macro environment and institutional profile by using a matrix, and add the consideration of other adjustment factors to generate the Baseline Credit Assessment ("BCA"). BCA includes both quantitative and qualitative determinants. In response to the risk characteristics among different types of insurers, such as life insurers and reinsurers, we would adjust the weighting or scoring standard for each factor and sub-factor. After the BCA, we will further incorporate the potential support from shareholders or the government to reach the final rating.

Exhibit 1. Overview of CCXAP's approach to insurer's rating assessment



This methodology provides general guidance in assigning ratings to an insurer, but it does not include an exhaustive description of all factors that CCXAP may use in its rating considerations. As a result, the mapped rating may not match the final rating for each rated entity.

Baseline Credit Assessment

CCXAP employs the Baseline Credit Assessment ("BCA") to evaluate the standalone risk of an insurer. The BCA is intended to explain the risk of an insurer that fails in performing its obligations in the absence of external support from the government or shareholders. It mainly consists of three components: (1) macro environment, (2) institutional profile, and (3) other adjustment factors. The assessment is based on our forward-looking expectations and the historical results of the rated entities.

1. Macro Environment

The macro environment over time has a meaningful influence on an insurer's operation as well as its business and financial profile. We intend to capture relevant factors such as economic, social and political factors, general business conditions and industry environment of countries where an insurer operates in. In our view, the macro environment is more material for a developing country where the structural strength of the insurance industry and contractual execution are in doubt, while it is of less concern in a developed country with a good operating environment. When assessing the macro environment where an insurer operates, we will consider (1) sovereign risk and (2) industry risk. For insurance groups that often consist of subsidiaries operating in more than one geographic region, a blended approach will be applied to evaluate the macro environment score. In this case, certain subsidiaries that are important measured by assets, revenue or other key metrics will be considered and the score will be generated on a weighted average basis.

(1) Sovereign Risk

We typically consider the sovereign rating that an insurer operating in as a starting point for evaluating a country's sovereign risk or through an internal assessment based on our rating methodology for sovereign, which captures most country-specific risks. Evaluation of sovereign risk includes a country's fundamental strength, institutional strength, and event risk. Countries that have higher sovereign risks tend to provide a weaker operating environment for insurers. For example, a greater risk of political turmoil or economic conditions could make business conducting more difficult and the impact of regulatory changes may be hard to manage for an insurer. In addition, insurance operations will be impeded by low contract enforceability, property rights protection or financial reporting transparency. The lower the sovereign risk, the better score in this factor.

(2) Industry Risk

Insurance markets differ among countries in terms of the degree of development, market structure and general business norms. CCXAP measures the industry risk by mainly looking into the insurance penetration and density for a particular country. Insurance penetration indicates the level of development of insurance sector while insurance density considers the sector's importance relative to the population base of a country. We typically use the market size of the insurance sector relative to a country's national economy to evaluate insurance penetration and the market size of insurance sector relative to a country's population base to evaluate insurance density. In our view, the higher the penetration and density levels mean the more developed market and the less insurance industry risk. We also consider other factors such as entry barriers, growth potential, and internal and external competitive environment.

2. Institutional Profile

To determine an insurer's institutional profile, we evaluate its (1) market and competitiveness position, (2) distribution channels, (3) products risk and diversification, (4) profitability, (5) asset quality, (6) capital adequacy, and (7) financial flexibility.

(1) Market Position and Competitiveness

Market position and competitiveness are reflection of an insurer's ability to develop its competitive advantages and maintain sustainable business growth in a particular market. An insurer's market position and competitiveness correlate to its future profitability and the long-term ability to generate capital internally. The main factors to be considered include an insurer's relative and absolute market share, entry barriers, pricing power, reputation, brand recognition, and customer loyalty. We believe an insurer with large absolute and relative market share in a specific market to be more resilient during the harsh market condition and is better to capture potential business opportunities in the future. Additionally, brand recognition from end customers and the market is vital to an insurer as a financial institution which will affect its service lines such as product distribution cost, new business generation, and customer retention. An insurer with a strong market position and competitiveness generally receives a better score in this factor.

(2) Distribution Channels

The methods and channels to deliver its products to the markets are important factors to assess an insurer's intuitional profile. An insurer's ability to access different distribution channels and the degree of control of channels have high linkages to the stability of income generation, market shares, business growth, and better cost management. The diversity in an insurer's distribution channels can reduce the dependence on a specific channel and its vulnerability to sales disruption. When assessing an insurer's distribution channels, we not only consider the number of channels but also the efficiency of those channels. Self-owned channels such as platforms provided by parent companies or personnel agencies are more controllable channels compared with third-party insurance brokers. Having stable and diversified distribution channels is positive for an insurer, which can help protect its customer source and product sales. High dependence on a single distribution channel or frequent changes in distribution channels is generally negative to an insurer, which will be scored lower.

(3) Product Risk and Diversification

An insurer's chosen line of business and product offering have a high impact on its risk profile and creditworthiness because different products generate unsimilar undertaking risks. Product risk is in many forms and can have significant adverse effects on an insurer's profitability and capital adequacy. Product risk from newly introduced products is often not fully known, or the prediction of such risk is yet to be completely tested. Product premium, thus, may be insufficient to cover its cost, and insurers may face higher unexpected losses. Diversification in product lines or adding low-risk ancillary business, if appropriately managed, can help mitigate the risk of a single product. An insurer who offers well-diversified products across different industries or geographic regions may have less susceptible earnings, capital, and cash flow. Generally, life insurers have a higher percentage of low-risk products, such as traditional life insurance products, while P&C insurers undertake higher product risk given the nature of loss frequency and severity.

(4) Profitability

An insurer's earnings capacity is a key factor to evaluate its institutional profile because it determines the long-term ability to meet policy and financial liabilities. It also helps ensure an insurer's access to the capital markets with favorable terms. An insurer's earnings are the primary source of internal capital generation to assure its capital adequacy. We typically use the return on capital (ROC) ratio to measure an insurer's overall profitability and efficiency by using its equity capital and debt funding. The evaluation of historical and expected changes in such ratios helps us to understand the sustainability and volatility of an insurer's profitability over time. An insurer that has a high and stable ROC ratio with a reasonable capital structure will be scored better in this factor. We also consider other metrics to compare a specific insurer's profitability with its peers, such as the combined ratio for P&C insurers and new business value ratio to for life insurers. We may adjust downward for an insurer's profitability score if it has lower metrics compared with peers.

(5) Asset Quality

Asset quality is an essential part of an insurer's institutional profile. An insurer's core assets comprise mainly liquid assets because it has to reserve high-quality assets to meet timely funding needs for potential claims. Nevertheless, many insurers are eager to allocate a portion of their investment portfolio to high-risk assets in order to earn extra income. We typically assess an insurer's asset quality by the relative level of its high-risk assets. High-risk assets broadly comprise of investments other than investment-grade bonds or loans such as non-investment-grade bonds and loans, common and preferred stock equities, as well as alternative investments such as commodities, private equity, hedge funds, and real estate. These types of assets usually have higher risks regarding counterparties, liquidity, and price volatility. An insurer with high exposure to high-risk assets is normally credit negative because of bearing higher asset risks in its investment portfolios. Some insurers, like mutual insurers, however, are able to have a higher tolerance to high-risk assets as they can pass much of the asset risk to their policyholders. We also consider an insurer's exposure to reinsurance and the size of goodwill and intangible assets. Some insurers may provide reinsurance services to other insurers, resulting in high reinsurance receivables which may increase their asset risk. Goodwill and intangible assets are derived from acquisitions and new business production of which the economic value is often uncertain.

Frequent or material write-downs of intangible assets indicate poor asset quality and will lower the score in this factor.

(6) Capital Adequacy

Capital is a critical part of an insurer to absorb losses from unfavorable changes. An insurer's capital adequacy can provide information to its customers, regulators and other stakeholders about the available capital that could cover losses stemming from an insurer's business and financial risks, including from remote loss scenarios. Capital constraints can negatively impact an insurer's ability to grow its business. An insurer is also often required by the local regulator to maintain minimum capital levels for business operations. We mainly consider the core solvency adequacy ratio which measure the adequacy of high-quality capital for insurers to generated the score. Regulators in different regions have developed more refined measures such as monitoring capital adequacy and solvency ratio to monitor the risks of the local insurance industry, which are also useful in our assessments. For example, Chinese regulators employ China Risk-Oriented Solvency System II (C-ROSS II), US regulators employ Risk Based Capital Standards (RBC), and the European Union largely employs Solvency II. We may consider other supplementary factors for different insurers, such as underwriting leverage, catastrophe excess reinsurance exposure and loss reserve adequacy for consideration of reinsurers' credit profile. Inadequate or unfavorable development of loss reserves may, in a worse case, cause failures of reinsurers.

(7) Financial Flexibility

Financial flexibility measures the ability of an insurer to meet its obligation and raise capital externally, which is also important to an insurer's institutional profile. It is considered by both qualitative and quantitative approaches including an insurer's ability to access external capital and metrics such as leverage ratio and coverage ratio. With strong access to capital, it will enable an insurer to raise additional funds for growth or acquisitions and to meet unexpected financial needs. We will also evaluate the depth of capital market where an insurer operates. A thin capital market may limit the external financial flexibility of an insurer even though it has a good income and assets base. Metrics such as coverage ratio, measured by earnings before interest and taxes divided by interest expense and dividend expense, and leverage ratio, measured by debt divided by equity plus debt, are quantitative indicators for financial flexibility. An insurer with a higher coverage ratio and lower leverage ratio generally will be scored better in this factor.

3. Other Adjustment Factors

CCXAP may consider other factors that are not included in the above rating factors but they may have a meaningful effect on an insurer's credit profile in some cases. Additional considerations may include liquidity, event risk, regulatory considerations, and ESG assessment.

(1) Liquidity

Liquidity is particularly critical for an insurer with a relatively weak credit profile. Liquidity measures an insurer's ability to meet short-term commitments and obligations to policyholders and other creditors. We may use an insurer's liquidity coverage ratio (LCR) as a measure of its liquidity. A lower LCR may indicate a weaker ability to withstand a stressed operating environment. We may make a downward adjustment for an insurer with low liquid buffers.

(2) Event Risk

We also recognize the possibility that a sudden or unexpected event may cause a sharp decline in an insurer's creditworthiness, which could result in the actual rating being lower than those indicated on the scorecard. Unexpected events can include M&A, asset sales, spin-offs, litigation, pandemics, and significant cyber-crime events. Such events can overwhelm even a stable and financially sound insurance company.

(3) Regulatory Changes

Although regulatory changes are not directly tied to the economy, changes may be necessary for response to other factors such as pricing levels and underwriting results. Regulatory changes are typically targeted to selected lines and markets. Constraints imposed by regulators in the form of mandated rate rollbacks, extraordinary assessments, and mandatory market lock-in arrangements in catastrophe-prone areas can adversely affect a rating unit.

(4) ESG Assessment

ESG assessment mainly evaluates the impact of credit risk-related environmental, social and governance factors on the credit strength of an insurer. The impact of ESG assessment on an insurer's credit risk is often negative, such as social instability caused by serious social security problems, deterioration of the living environment due to environmental pollution, and reduced governance capacity due to sudden security incidents.

External Support

In terms of external support, CCXAP considers both parent company support and government support that an insurer would receive to decrease the likelihood of default.

Shareholder Support

The support from shareholders is conducive to the company's future development and overall creditworthiness. In assessing shareholder support, CCXAP considers the nature of the holding company, business competitiveness, and financial status. In addition, CCXAP considers the company's development strategy, market position, ownership structure and importance to its shareholders to evaluate the availability of shareholder support in times of need.

Government Support

Government support means that when a company is facing severe pressure of debt servicing, the government would provide support to pay for the company's debt or take other actions to avoid default. In assessing the support from the government, CCXAP considers factors such as the importance of the company's assets to the government, the legal requirements and degree of oversight from the government, government support and bailout histories, and the financial strength of the government.

Assumptions and Limitations

The final ratings assigned are based on CCXAP's forward-looking opinions, which we assume any changes in the macro environment are aligned with our expectations, and do not incorporate any unanticipated changes, such as the outbreak of war and destructive natural disaster.

CCXAP assumes that there is a strong correlation between the sovereign credit risk and the rated entity while refinancing capability is the key driver of credit risk. The debt rating assigned is based on our view that the legal priority of claims is the key factor affecting the ratings for different classes of debt issued by the same issuer. Also, we assume that the data used in the rating is true, legal and does not incorporate misleading statements.

The ratings incorporate our expectations of the rated entity's future performance, which are mainly deduced from the historical information via our forward-looking model. Under some circumstances, the expectations would incorporate confidential information. In addition, our expectations would consider the industrial trend, rival analysis, and other considerations. In any case, prediction is subject to substantial uncertainty. Therefore, the mapped ratings may not match our final ratings. The ratings may include some qualitative factors. CCXAP would evaluate these factors in an objective and precise approach, but the assessment may be unavoidably affected by subjective views in some cases. Therefore, the weighting of rating considerations could be varied. Specifically, the variation in weighting would happen if the rated entity were in default or approaching to be in default.

Furthermore, the ratings rely on public information and information provided by the rated entity and underwriters. Despite the fact that CCXAP can ensure the integrity, truthiness, and completeness of the data, due to the delay of information, the ratings may on some occasions not reflect the rated entity's credit risk in a timely manner.

Apart from that, the ratings are decided by our rating committee and could be influenced by their empirical views which may not be incorporated in the rating methodology. As a result, the final ratings could be varied with the mapped rating from the methodology.

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