Not All Insurer Financial Strength Ratings Are Created Equal

White Paper on Lack of Comparability of A.M. Best's 'A-' IFS Ratings to Those of Fitch

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EXECUTIVE SUMMARY

This white paper was prepared by Fitch Ratings to help users of Insurer Financial Strength (IFS) ratings, including insurance brokers and reinsurance security teams, put the ratings of the main credit rating agencies (CRAs) into better perspective. Fitch believes there are common misperceptions with respect to the comparability of IFS ratings among CRAs, particularly for ratings at the 'A–' level.

Our key conclusion is that an IFS rating of 'A–' from A.M. Best is most comparable with a 'BBB' IFS rating from Fitch, as well as Moody's and Standard & Poor's (S&P).

Throughout this white paper we provide anecdotal evidence that demonstrates this lack of ratings comparability. It is most apparent with newly formed companies, insurers located in countries with high country risks, captives and smaller insurers.

In addition, we examined historical statistical ratings performance by comparing default and impairment rates by rating category (over a 25- to 37-year period), using data reported to regulators by the various CRAs. This analysis indicates that the historical impairment rate for A.M. Best's 'A–' IFS rating is approximately 7% (estimated by Fitch). This is significantly higher than the estimated 2% historic default rate for Fitch's 'A–' ratings, and falls between Fitch's 6.3% default rate at 'BBB' and 9.7% at 'BBB–'. Fitch recognizes impairments are expected to occur at a higher frequency than defaults. However, Fitch also believes the noted difference at 'A–' falls outside normal impairment versus default expectations.

We believe the lack of ratings comparability reflects a combination of differences with respect to how certain risks are weighed in the respective CRAs' ratings criteria, and the fact that the IFS ratings scale used by A.M. Best does not directly map to the rating scales used by the other noted CRAs.

Based on our findings, IFS ratings users that treat the 'A–' IFS ratings of all four CRAs as directly equivalent are misestimating credit risk and, therefore, should consider adjusting their ratings standards accordingly. Specifically, Fitch believes the equivalency should be changed to 'BBB' for Fitch, as well as Moody's and S&P, and retained at 'A–' for only A.M. Best. This also coincides with how capital markets view debt ratings, where debt ratings in the 'BBB' category (and above) are considered investment grade.

Inaction by ratings users will potentially perpetuate the unintended consequences of:

- Less informed (re)insurance security decisions,
- Higher risk of exposure to unexpected (re)insurer insolvencies and unpaid claims, and
- Fewer ratings opinions available in the marketplace for ratings users to consider.

Furthermore, Fitch believes that misaligned ratings standards used by many ratings users also encouraged so-called "ratings shopping" by (re)insurance company management. Specifically, many (re)insurers are incentivized to only seek A.M. Best IFS ratings, since an 'A–' IFS rating is often more readily achieved than from the other CRAs.

Note, this analysis does not suggest that A.M. Best's approach is wrong. Rather, it suggests that A.M. Best's approach is different, and that this difference, in turn, makes A.M. Best's ratings less comparable with those provided by Fitch and the other CRAs.

Further, we believe most IFS ratings users are either simply not aware that such differences exist, or if they are aware, they are not appreciative of the magnitude of the differences. This white paper is intended to provide additional transparency around this important issue.

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PART ONE — BACKGROUND

What Is an IFS Rating?

IFS ratings are assigned to insurance and reinsurance companies, and speak to the likelihood that policyholder obligations will be paid in full and on a timely basis. The focus of the IFS rating on policyholder obligations distinguishes it from credit ratings more broadly used by investors across the capital markets that are assigned to debt obligations.

Which Credit Rating Agencies Provide IFS Ratings?

The most significant providers of IFS ratings are A.M. Best, Fitch, Moody's and S&P. A.M. Best is a specialty rating agency focused primarily on the insurance industry. It was the first CRA to provide IFS ratings[1] and it offers the broadest IFS ratings coverage[2]. Fitch, Moody's and S&P have a more diverse analytical scope than A.M. Best, and provide ratings across essentially all industries — most of their ratings are debt ratings used by institutional investors. Fitch, S&P and Moody's added IFS ratings to their ratings coverage beginning at different times in the mid-1980s through 1990s[3].

How Do (Re)Insurers Obtain IFS Ratings?

IFS ratings can be obtained by a (re)insurer in one of two ways: the (re) insurer can ask the CRA to provide an IFS rating, or the CRA can initiate an IFS rating on an unsolicited basis.

In the case of an IFS rating requested by the (re)insurer, typically a fee is paid to the CRA by the (re)insurer for the rating. Prior to a newly requested rating being finalized and published under Fitch policies, the (re)insurer is made aware by Fitch of the expected rating outcome, and the (re)insurer usually has the option for the rating not to be made final and to remain unpublished subject to certain conditions. Often, the (re) insurer will keep the indicated rating unpublished if the rating is lower than its expectation. However, once a rating is published, the insurer no longer has the option to keep any rating actions unpublished under Fitch policies.

Unsolicited ratings are used by CRAs when the CRA believes the marketplace would benefit from the agency broadening rating coverage to include certain (re)insurers that have not sought a rating. Unsolicited ratings do not involve a fee, and represent an investment of resources and costs by the CRA that is not directly compensated. CRAs providing an unsolicited rating must rely exclusively on public information should the (re)insurer's management decide not to participate in the rating process. Thus from Fitch's perspective, certain types of (re)insurance companies typically cannot be rated on an unsolicited basis without management participation because public information is insufficient to support a rating. Examples are newly formed companies, where a review of management's plans and forecasts are important, and captives that do not publically release their financial statements.

There are regulations in place governing CRAs[4] that require rigorous controls that separate defined ratings and business activities and that govern how CRAs approach unsolicited ratings.

Why Are IFS Ratings Important to Insurance Markets, and How Are They Used?

IFS ratings are used in the insurance marketplace to help buyers of insurance or reinsurance judge if the (re)insurer is likely to remain solvent and able to meet claim payments when they come due. Key users of IFS ratings include broker security personnel, clients of brokers who rely on broker advice, insurance regulators who monitor (re)insurer solvency and/or establish capital standards based on ratings, ceded reinsurance teams, corporate risk managers, fronting companies for captive (re)insurance arrangements, as well as other intermediaries who assist clients with insurer selection decisions.

While the exact standard used by IFS rating users may vary, most commonly, IFS rating users employ a minimum 'A–' IFS rating standard, particularly in developed markets. Stated another way, typically IFS ratings users will place (re)insurers on their "approved list" if they are rated 'A–' or higher and leave the companies off their approved list if rated below 'A–'. The 'A–' IFS "standard," therefore, plays a critical role in the (re)insurance markets.

(Re)insurers are aware of the 'A–' IFS standard used by most insurance market participants in developed markets. Thus, it is rare that a (re) insurer will seek to publish a solicited IFS rating that is below 'A–'.

What Scale and Rating Symbols Are Used for IFS Ratings, and Do They Differ Among Agencies?

The IFS ratings symbols and definitions used by the CRAs are very similar across Fitch, S&P and Moody's, but there are important differences for A.M. Best.

IFS Rating Scales

Agency	Insurer Financial Strength (IFS) Rating Scale
A.M. Best	A++, A+, A, A–, B++, B+, B, B–, C++, C+, C, C–, D
Fitch	AAA, AA+, AA, AA–, A+, A, A–, BBB+, BBB, BBB–, BB+, BB, BB–, B+, B, B–, CCC, CC, C
S&P	AAA, AA+, AA, AA–, A+, A, A–, BBB+, BBB, BBB–, BB+, BB, BB–, B+, B, B–, CCC+, CCC, CCC–, CC, C
Moody's	Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca, C

Source: Fitch Ratings.

As can be seen in the table above, the IFS rating scale used by Fitch is a 19-category scale, ranging from 'AAA' through 'C'. S&P uses a very similar scale and symbols as Fitch[5], with the main difference being use of plus and negative signs at 'CCC'. Moody's uses the same scale but slightly modifies its symbols[6], using 'Aaa' instead of 'AAA', 'Aa1' instead of 'AA+', and so forth.

In sharp contrast, A.M. Best currently uses a 13-category scale for its IFS ratings, and prior to 1992, the scale was just seven categories (the double plus and negative designations were not used).

The difference in scales and symbols used by A.M. Best relative to the other CRAs presents fundamental challenges in defining points of comparability that have long been confusing to many market participants. In fact, several years ago, around the time A.M. Best added insurance debt ratings to its coverage, the agency introduced a parallel Issuer Credit Rating scale[7]. This scale more closely aligns with the scales and symbols of the other CRAs that are more familiar to institutional investors.

PART TWO — COMPARABILITY ISSUES AT 'A–'

There are four key situations where Fitch observed a significant difference in application of the 'A–' IFS rating between A.M. Best and Fitch. Stated another way, Fitch recognizes a number of situations under its methodologies where Fitch will rarely rate a (re)insurer as high as 'A–'. However, under A.M. Best's methodologies, as applied to A.M. Best's unique rating scale, an 'A–' IFS rating can be frequently achieved.

The four noted situations are: newly formed (re)insurers, insurance companies with high country risks (i.e. low sovereign ratings), captives and smaller-sized insurers.

1. Newly Formed (Re)insurance Companies

Fitch's ratings criteria, with very limited exceptions, does not allow for IFS ratings of 'A–' or higher to be assigned to newly formed (re)insurance companies[8]. A.M. Best, on the other hand, regularly assigns ratings of 'A–' to newly formed companies if certain criteria are met[9]. More recently, this included some "hedge fund" reinsurers (i.e. a reinsurer sponsored by a hedge fund that in turn invests a significant portion of its assets in that hedge fund)[10].

Fitch's belief is that even with strong management and a well-thought-out strategic plan (coupled with reasonable levels of initial capitalization) that there are inherent uncertainties for any newly formed company that are inconsistent with the risk level associated with an 'A–' IFS rating.

A.M. Best's publicly available materials on this subject also recognize that there are noteworthy uncertainties linked to newly formed companies not found in established companies. But in calibrating those uncertainties to its unique ratings scale, A.M. Best will rate newly formed companies at the 'A–' IFS rating category.

This potentially implies that even if Fitch and A.M. Best held the same view of the risk that a given newly formed company may become financially distressed, that the two agencies could theoretically assign a different rating — an IFS rating of 'A–' by A.M. Best and an IFS rating in the 'BBB' category by Fitch.

Fitch believes it is important to remind market observers that our criteria allow Fitch to assign ratings to newly formed companies. There is no minimum three- or five-year standard for a company to be rated. Fitch simply believes the risks in the first five years of operations preclude an IFS rating higher than 'BBB+'. A.M. Best does not hold the same view.

2. High Country Risks/Low Sovereign Ratings

One of the more challenging aspects of credit analysis is judging how a rated entity's macroeconomic environment affects its creditworthiness. Economic and political factors become especially acute when the country of domicile/operation is under some financial stress.

The approach to country and sovereign risks is a further point of difference between the insurance ratings of A.M. Best and Fitch, as well as S&P and Moody's. One of the key rating inputs available to Fitch, S&P and Moody's are sovereign ratings assigned to various countries around the world, which address a country's ability to meet its own debt obligations. Sovereign ratings also act as a proxy for measuring macroeconomic risks.

In Fitch's view, the appropriate relationship between a (re)insurer's IFS rating and the rating of a sovereign is judgmental. That said, in many but not all cases, Fitch will not rate an insurance company's IFS rating higher than the sovereign rating[11]. In effect, the more linked the (re)insurer is to the country of domicile, the less likely Fitch will rate the entity above the sovereign. This linkage becomes especially strong when a (re)insurance company holds significant proportions of its investment portfolio in government debt or local bank debt/deposits. Such holdings directly align default risk on the sovereign to risk that the (re)insurer will also become distressed.

Fitch is most likely not to employ a sovereign constraint for (re)insurers in countries, such as Bermuda, where essentially all business and assets are derived/held outside of Bermuda, and thus shielded from local country risk. In this case, the linkage between the sovereign and (re) insurer is minimal.

In contrast, A.M. Best's analysis seems to place much less weight on country/sovereign risks, as A.M. Best will often assign IFS ratings that are above the sovereign ratings of Fitch, S&P and Moody's. This appears to be the case even when the previously noted linkages between the sovereign and (re)insurer exist. The following is a list of select countries where Fitch notes A.M. Best assigned at least one (re)insurance company an IFS rating of 'A–' or higher (where the uplift above the sovereign does not appear to relate to ownership/support by a foreign parent), and where the Fitch local currency sovereign rating is below 'A–'[12].

Countries with 'A–' or Higher A.M. Best IFS Ratings

Country	Fitch Local Currency Sovereign Rating
Brazil	BB
Costa Rica	BB+
India	BBB–
Panama	BBB
Slovenia	BBB+
Spain	BBB+

Source: Fitch Ratings.

In addition to comparability issues between the different CRA rating scales, Fitch believes these differences reflect A.M. Best's apparent philosophical viewpoint that country-related risks are not as relevant for a number of (re)insurers as considered by Fitch. As noted, A.M. Best does not publish sovereign ratings. However, A.M. Best states that it conducts a multitier country risk assessment, with country risk ranked on a scale of one through five[13].

Regardless of which approach is considered more appropriate (this is ultimately for ratings users to judge), what is clear is that A.M. Best's approach results in higher IFS ratings in lower rated countries compared with the IFS ratings of Fitch.

3. Captives

Captive ratings clearly highlight the awkwardness of the use of a uniform 'A–' IFS rating standard across all rating agencies. They also point out how relative limitations in a rating agency's ratings process may influence the analytical perspective employed.

Fitch's rating criteria indicates that core captives, such as those serving as the self-insurance arm of an industrial corporate, are effectively extensions of the parent company's credit quality. As such, Fitch will typically set the IFS rating of core captives at the same level as the parent's primary credit rating, the Issuer Default Rating (IDR)[14].

A.M. Best does not rate industrial corporate companies, nor does it rate most non-insurance financial institutions[15]. A.M. Best's criteria for rating captives also does not focus on the same issues as Fitch. Instead, A.M. Best typically rates a core captive based heavily on the balance sheet and operating profile of the captive itself, or stated another way, based on its "stand-alone" profile[16]. There is often only limited consideration given to the parent company's credit quality.

The result of this approach is that captives rated by A.M. Best can often be rated at levels of 'A–' or above, even when the parent is rated less than 'A–' by Fitch, S&P and/or Moody's[17].

Fitch notes that in many jurisdictions, captive regulation is relatively light, and in such cases, parent companies have relative ease in accessing the captive's assets (i.e. via a loan-back of a portion of the captive's assets to the parent) or capital (i.e. via a dividend). In fact, when captives plan to write statutory lines of insurance, such as workers' compensation in the U.S., most regulations strongly incent that a fully regulated and licensed fronting insurance company is used to stand between the captive and any third-party claimants. The use of a front mitigates the "lightness" of the regulation of the captive, and the risks implied in linking the captive's credit quality to that of the parent.

Ironically, the insurance captives of 'BBB' category parent companies would likely be viewed as unacceptable to many insurance market participants if the captive carried a 'BBB' IFS rating from Fitch (based on the parent's rating), yet the debt of these same 'BBB' category parent companies is readily acceptable to the largest institutional investors in the world that target safe, investment-grade, fixed-income investments.

Fitch recognizes that some IFS rating users may not have much exposure to 'BBB' category ratings used in the debt capital markets. Thus, to further put the 'BBB' category in perspective, and to demonstrate that ratings in that category assigned by Fitch are not routinely assigned to inconsequential organizations, to the above right is a select list of industrial corporate entities whose IDRs fall in the 'BBB' category by Fitch. Readers should note that these are all very large, established institutions with high-quality, brand-name franchises and high levels of financial flexibility.

Captives are another situation in which A.M. Best applies a different rating methodology to a different rating scale, and the outcome is often 'A–' or a higher IFS rating in cases when Fitch would rate in the 'BBB' category. Given the financial and operational linkages between captives and their parents, captives are arguably the most obvious case where the use of a uniform 'A–' IFS rating standard, and the shunning of the 'BBB' category, is inappropriate.

Select 'BBB' Category U.S. Corporates Rated by Fitch

Baxter International Inc.
CBS Corporation
Coca-Cola Enterprises, Inc.
eBay Inc.
Northrop Grumman Corp.
Macy's Inc.
McDonald's Corporation
Southwest Airlines Co.
Tyson Foods, Inc.
Whirlpool Corp.

Note: Ratings based on Issuer Default Ratings.
Source: Fitch Ratings.

4. Smaller-Sized Insurers

A.M. Best has a much higher propensity to assign a rating of 'A–' or higher to smaller insurers than does Fitch. A.M. Best rates most small insurers in the U.S., whereas the other CRAs' coverage of small insurers is quite limited[18].

In Fitch's insurance criteria "small" U.S. insurers are defined as having capital and surplus below $750 million for a property/casualty (P/C) insurer, and $1 billion for a life insurer. Further, if an insurer is designated as small under our criteria, the size-related component of our IFS rating will be scored no higher than 'BBB'[19]. This is because often smaller companies are more vulnerable to competition from larger companies with greater resources, have less diversification and lower levels of financial flexibility, among other limitations.

While the size-related component of our criteria does not formally cap an IFS rating, this factor becomes heavily weighted for many smaller companies, especially if capital is well below the thresholds discussed above. To put this in perspective, while Fitch does not have public ratings on many smaller insurance companies in the U.S., Fitch has historically maintained private (i.e. unpublished) ratings and opinions on numerous smaller insurance companies in support of legacy collateralized debt obligations rated by Fitch (i.e. poolings of debt issued by smaller insurers). A vast majority of these smaller insurers have been assigned private ratings, opinions or scores no higher than the 'BBB '(or equivalent) IFS rating category by Fitch.

In contrast, based on information in the preface of the 2015 *A.M. Best's Insurance Reports*, more than 75% of the more than 850 U.S. P/C insurance groups rated by A.M. Best carry IFS ratings of 'A–' or higher. Of these 850 U.S. P/C groups rated by A.M. Best, approximately 85% have capital and surplus below $750 million. For the more than 400 U.S. life insurance groups rated by A.M. Best, Fitch estimates that over 65% carry 'A–' or higher A.M. Best IFS ratings, and approximately 80% of the more than 400 A.M. Best-rated life groups have capital and surplus below $1 billion.

From these figures, one can easily extrapolate that a significant proportion of U.S. P/C and life insurers designated as small by Fitch have 'A–' or higher IFS ratings from A.M. Best.

In understanding A.M. Best's perspective on size and ratings, it is important to note that for many decades, in addition to providing IFS ratings, A.M. Best also publishes a Financial Size Category (FSC) for each (re)insurer it rates. There are 15 A.M. Best FSCs ranging from roman numerals I (less than $1 million in capital) through XV (over $2 billion in capital). A.M. Best clearly views size as an important consideration for market participants to consider.

While the formal use of FSCs across the insurance marketplace varies, Fitch understands that some insurance ratings users who employ an IFS rating standard of 'A–' also employ a minimum A.M. Best FSC standard. Thus, these market participants may remove from their approved lists smaller carriers even if they have an IFS rating of 'A–' or higher from A.M. Best. The screening out is not via the IFS rating, but because the insurers are small and achieve a low FSC.

Size appears to highlight a meaningful inconsistency in both the criteria and the IFS rating scales between A.M. Best and Fitch. A.M. Best's parallel use of IFS ratings and FSCs appears to be a key manner in which they address size-related risks, in which size is apparently addressed at least partially via the FSC, and risks other than size seem to more heavily influence the IFS rating. The approach used by Fitch combines all risks, including size, in the single IFS rating.

PART THREE — RATINGS PERFORMANCE DIFFERENCES

Impairment and Default Studies

One objective way to judge ratings comparability is to look at relative ratings performance across the various CRAs over time, by rating category. As part of their regulatory oversight, the CRAs must report to regulators on an annual basis the performance of their ratings. Such default and impairment studies are a key way ratings users can judge ratings comparability.

Fitch published its most recent analysis of cumulative default rates for its corporate finance ratings in May 2016[20]. This study focuses on ratings performance of all corporate and financial industries rated by Fitch. It covers the years 1990–2015. While non-insurance entities make up a vast majority of the data included in the study, Fitch's criteria and methodologies are designed with a goal that ratings across industries, sectors and regions are comparable and imply similar levels of credit risk[21]. This default study is freely available on Fitch's website and is filed with the SEC and other regulators globally.

Like Fitch, both Moody's and S&P publish annual default studies on the historical performance of their ratings. Details can be found on their respective websites and in their regulatory filings[22].

In August 2015, A.M. Best updated its historic U.S. insurance industry impairment study[23]. A.M. Best provides cumulative insurer impairment rates, by rating category, for U.S. life and P/C insurers covering the years 1977–2014. This report is freely available as part of A.M. Best's regulatory filings with the Securities and Exchange Commission (SEC) in the U.S. as part of Form NRSRO.

Fitch notes that impairments and defaults are not the same thing. Defaults typically include missed interest or principal payments on debt, as well as distressed debt exchanges and bankruptcy filings. Impairments include not only missed claim or benefit payments (which are difficult to measure/observe), but also intervention of a regulator in an insurer's operation due to financial solvency concerns (such as a dangerously low capital ratio), liquidation, conservatorship, supervision, rehabilitation, license revocation and other similar actions.

Impairments would be expected to occur at a somewhat higher frequency than defaults, though Fitch is not aware of any statistical data or studies that define the exact degree of that difference. Fitch believes the difference to be moderate, however, as the noted definitions of impairment denote extreme financial distress that typically results in cessation of a (re)insurance company's operations.

A.M. Best Results Differ

In general, the various default studies of Fitch, Moody's and S&P indicate that historic default rates by rating category are similar for all three CRAs. However, impairment rates by rating category reported by A.M. Best vary significantly relative to the default rates of the other CRAs.

Notably, the A.M. Best impairment study combined its 'A' and 'A–' IFS rating categories into a single measurement category. As discussed earlier in this report, the 'A–' rating was introduced in 1992, so a full history does not exist for that category back to 1977.

A.M. Best reports a 10-year cumulative impairment rate of between 5% and 6% for the combined 'A'/'A–' IFS rating categories. At the next higher combined rating level of 'A++'/'A+', A.M. Best reports an approximate 2% impairment rate, and at the next lower combined IFS rating level of 'B++'/'B+', A.M. Best reports an impairment rate slightly below 13%. Using simple extrapolation, Fitch believes it would be reasonable to assume an approximate 7% cumulative 10-year impairment rate for the 'A–' A.M. Best IFS rating.

Looking at the 'A' and 'BBB' categories, Fitch reports a 10-year cumulative default rate of 0.54% at 'A+', 2.17% at 'A', 1.94% at 'A–', 1.94% at 'BBB+', 3.62% at 'BBB', 6.34% at 'BBB–' and 9.70% at 'BB+'. The default rates align with IDRs. Typically, Fitch's IFS ratings are set one notch above an insurance company's IDR. Thus, default rates implied for the Fitch IFS rating should be shifted by one notch, as follows: 0.54% at 'AA–', 2.17% at 'A+', 1.94% at 'A', 1.94% at 'A–', 3.62% at 'BBB+', 6.34% at 'BBB' and 9.70% at 'BBB–'.

Fitch's estimate of 7% as the impairment rate for A.M. Best's 'A–' IFS rating implies a level of risk that is much higher than the Fitch 'A–' IFS rating (2% default rate), and falls between the 'BBB' and 'BBB–' IFS ratings from Fitch (6.3%–9.7% default rate range).

A.M. Best Impairment Rate Versus Fitch Default Rate at 'A–'

A.M. Best Insurer Financial Strength Rating	A.M. Best Estimated Impairment Rate at 'A–'	Fitch Default Rate at 'A–'	Closest Fitch IFS Rating to A.M. Best 'A–' Impairment Rate
A–	7%	2%	BBB

Source: Fitch Ratings.

As noted, Fitch recognizes impairments are expected to occur at a higher frequency than defaults. However, Fitch also believes the noted difference at 'A–' falls outside normal impairment versus default expectations[24]. Nonetheless, readers are cautioned to keep the difference between impairments and defaults in mind when drawing their own conclusions. Fitch also believes that while historical ratings performance data is interesting, the discussions in *Part Two* of this report highlighting various criteria and rating scale differences form the core basis for Fitch's viewpoints and conclusions.

ADDRESSING THE DIFFERENCES

In Fitch's opinion, the material difference between A.M. Best's 'A–' IFS ratings and the IFS ratings of Fitch, as well as S&P and Moody's, means there are two key issues ratings users need to be aware of, as they have the potential to distort the insurance market: ratings shopping and misaligned ratings equivalency standards.

Market Distortion Caused by 'Ratings Shopping'

Ratings shopping is a term used to describe the practice undertaken by rated entities to find the CRA that they believe will assign it the highest rating and to avoid ratings from the other CRAs. As previously discussed, in the developed (re)insurance markets, companies routinely seek out IFS ratings of at least 'A–' in most sectors and will avoid CRAs that assign lower IFS ratings. In each of the four situations described earlier in this white paper, ratings shopping by (re)insurer management has resulted in A.M. Best being selected as the only CRA in many cases.

Ratings shopping skews the ratings coverage of the most optimistic opinion, thus severely limiting ratings coverage across other CRAs. This practice can put ratings users at significantly heightened risks when making a (re)insurance security decision, particularly in higher risk situations such as newly formed companies, companies in developing/emerging markets, smaller companies and captives.

As discussed earlier in this white paper, CRAs can partially dampen the impact of ratings shopping by expanding ratings coverage to the benefit of ratings users via use of unsolicited ratings. However, as also discussed earlier in this white paper, because of limitations of publicly available information, for certain sectors such as newly formed companies and captives, unsolicited ratings generally cannot be assigned without management participation. Also, because unsolicited ratings involve a cost expenditure by the CRA, there is a practical limit on the number of unsolicited ratings that can be maintained at any point in time. Fitch continues to make an investment of resources in unsolicited IFS ratings to the benefit of ratings users[25].

Remedies for Ratings Shopping

One of the most effective ways for ratings shopping to be addressed is for ratings users to more strongly request that (re)insurers obtain multiple ratings. This scenario would mirror the practice employed for decades in the debt capital markets, in which most investors will rarely (if ever) purchase the debt of an issuer if it does not have ratings from at least two of the three largest CRAs (in a number of sectors, ratings from three CRAs is the standard).

While movement to a minimum of two ratings still allows for some element of ratings shopping, the impact would be greatly dampened compared with the current case in the insurance markets of just one rating often being accepted.

In terms of the (re)insurance markets specifically, Fitch believes the major brokers' market security functions, both individually and collectively, could yield tremendous influence in helping move the market from its current overreliance on A.M. Best ratings, especially in the higher risk situations discussed throughout this white paper. The same ability to influence the market would hold true for major reinsurance buyers, especially for the case of newly formed reinsurers.

The issue can also be addressed by insurance regulators and their treatment of ratings in their (re)insurance company capital formulas. For example, in the U.S., the National Association of Insurance Commissioners' Risk-Based Capital Ratio (NAIC RBC) for P/C insurers includes credit risk-based capital charges for receivables on reinsurance ceded to non-affiliates. The capital charges vary based on an NAIC classification system, which uses a six-point scale ranging from "Secure 1" through "Secure 5" as well as "Vulnerable 6/Unrated".

The NAIC classifications are based on the IFS ratings of A.M. Best, Fitch, S&P and/or Moody's, using an equivalency table[26]. Unfortunately, in Fitch's opinion, consistent with broader market practices discussed earlier in this white paper, the Secure 4 classification aligns the 'A–' IFS ratings of all four CRAs.

Fitch believes the NAIC classification system would better serve the insurance marketplace if it aligned the 'A–' IFS rating of A.M. Best and 'BBB+'/'BBB' IFS ratings of Fitch, S&P and Moody's (the NAIC would need to decide if this would fit Secure 4 or Secure 5).

The IFS ratings used in the NAIC classification system must be based on an interactive process between the CRA and management, meaning unsolicited ratings based only on public information will not be used. This approach is highly problematic in Fitch's view, since it hampers a CRA's ability to help dampen the impact of ratings shopping via use of unsolicited ratings. It also effectively moves the choice on which CRA's ratings will influence NAIC capital charges solely to that of (re)insurance company management because by withholding nonpublic information from select CRAs, management has complete control over which CRAs' ratings are used by the NAIC.

Finally, under the NAIC's system, when there are multiple CRA ratings[27], the 1–6 classification is based on the lowest IFS rating. While Fitch applauds the intended conservatism of this approach, it also has the unintended consequence of promoting ratings shopping by (re)insurance company management to avoid a CRA that would assign a less favorable IFS rating than the other CRAs. In effect, it discourages rather than promotes the attainment of multiple ratings by (re)insurance company management.

Fitch believes there is an opportunity for enhancements to the regulatory use of ratings in the setting of ceded reinsurance capital charges[28].

Conclusion on Misaligned Ratings Equivalency Standards

In conclusion, Fitch believes IFS ratings users who employ a uniform 'A–' IFS ratings standard for A.M. Best, Fitch, S&P and Moody's should consider whether they need to reassess their practice. It is clear that such an approach results in an inconsistent risk assessment and exposes ratings users to a false sense of comfort. It can also result in unintended consequences that are detrimental to a well-functioning insurance marketplace, including encouragement of ratings shopping and the distortions that practice brings.

Specifically, if a ratings user currently uses an IFS ratings equivalency standard across all rating agencies of 'A–' to support their decisions on (re)insurance company security, Fitch believes the equivalency should be changed to 'BBB' for Fitch, Moody's and S&P, and retained at 'A–' for only A.M. Best.

FOOTNOTES

PART ONE — BACKGROUND

1. We use "IFS Ratings" in discussing all rating agencies throughout this report as a convenience. A.M. Best actually uses the phrase "Financial Strength Ratings". Moody's uses "Insurance Financial Strength Ratings."
2. Based on Fitch estimate.
3. Several rating agencies originally used the phrase "claims paying ability ratings". Year range is a Fitch estimate.
4. The primary regulators overseeing rating agencies are the Securities and Exchange Commission (SEC) in the U.S. and the European Securities and Markets Authority (ESMA) in the European Union, among numerous others in various countries.
5. See *S&P Global Ratings Definitions*: http://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352
6. See report Moody's *Investors Service Rating Symbols and Definitions*, February 2016.
7. See A.M. Best's *Issuer Credit Rating* Guide: http://www.ambest.com/ratings/icrguide.pdf

PART TWO — COMPARABILITY ISSUES AT 'A–'

8. See Fitch's *Insurance Rating Methodology*, Section VII at https://www.fitchratings.com/site/re/881564
9. See the following two criteria reports published by A.M. Best: *Rating New Company Formations* at http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=197691 and *Rating Reinsurance/Insurance Transformer Vehicles* at http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=227390 Also see article *A.M. Best's Sellek: A very singular focus* published by *Insurance Day*, Dec. 3, 2014.
10. Recent examples include Greenlight Capital Re, Ltd. (2006), Torus Insurance Holdings Ltd. (2008), PaCRe Ltd. (2012), S.A.C. Re Ltd. (2012), Third Point Reinsurance Ltd. (2012), Watford Re Ltd. (2014) and Fidelis Insurance Bermuda Limited (2015).
11. See Fitch's *Insurance Rating Methodology*, Section I.B. at https://www.fitchratings.com/site/re/881564
12. List was compiled by Fitch based on various searches at http://www3.ambest.com/ratings/entities/search.aspx
13. See A.M. Best's criteria report *Evaluating Country Risk Criteria*, published May 2, 2012 at http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=197697
14. See Fitch's *Insurance Rating Methodology*, Section X. at https://www.fitchratings.com/site/re/881564
15. Per Fitch, based on review of A.M. Best's website (under Industry and Market Centers).
16. See A.M. Best criteria report *Alternative Risk Transfer (ART)* published on Dec. 27, 2011 at http://www3.ambest.com/ambv/ratingmethodology/OpenPDF.aspx?rc=197659
17. See select A.M. Best captive ratings at http://www.ambest.com/captive/captiveupdate.pdf
18. All information in this section cited on A.M. Best is per *Best's Insurance Reports, 2015 U.S. Property & Casualty and Life/Health* editions. S&P and Moody's information is per review by Fitch of ratings listed on the agencies' respective websites.
19. See Fitch's *Insurance Rating Methodology*, Section I.D., as well as the Fitch Sector Credit Factor reports *Property/Casualty Insurance (U.S.)* and *Life Insurance (U.S.)*, at https://www.fitchratings.com/site/criteria/fi.html

PART THREE — RATINGS PERFORMANCE DIFFERENCES

20. See Fitch information at https://www.fitchratings.com/site/re/879357
21. In the report *Fitch U.S. High Yield Default Insight* dated May 18, 2016 at https://www.fitchratings.com/site/re/881533, Fitch published Insurance-specific default statistics (page 18). These indicate an average annual default rate from 2000 to 2015 of 3.6% for insurance compared with the overall corporate finance average of 4.3%. This insurance statistic is based on a limited number of insurance defaults, and thus may fluctuate in the future.
22. See Standard & Poor's *Global Corporate Default And Rating Transitions Study*, April 29, 2015 at http://www.spratings.com/documents/20184/774196/2015+Annual+Global+Corporate+Default+Study+And+Rating+Transitions/6d311074-5d56-4589-9ef8-a43615a6493b. See Moody's *Annual Default Study: Corporate Default and Recovery Rates, 1920–2015* (Excel Data) https://www.moodys.com/Pages/GuideToDefaultResearch.aspx
23. See *Best's Impairment Rate and Rating Transition Study — 1977 to 2014*, Aug. 21, 2015 at http://www.ambest.com/nrsro/FormNRSRO_Ex1_RatingsImpairment.pdf
24. In contrast, in its noted 2015 impairment study, A.M. Best suggests that an impairment is a substantially wider category of financial duress than an event of default, and that in A.M. Best's opinion, this leads to substantially higher impairment rates at any given rating level than would be observed purely using default data.

FOOTNOTES

ADDRESSING THE DIFFERENCES

25. To put this investment in perspective, approximately 17% of the U.S. insurance groups with public IFS ratings from Fitch are provided on an unsolicited basis.
26. See the publication, *NAIC Risk-Based Capital Forecasting & Instructions — Property/Casualty — 2015*, pages 13–15 and PRO12A. Secure 1 is defined as 'A++' from A.M. Best and 'AAA' from Fitch, S&P and Moody's; Secure 2 is 'A+' from A.M. Best and 'AA+'/'AA'/'AA–' from Fitch, S&P and Moody's; Secure 3 is 'A' from A.M. Best and 'A+'/'A' from Fitch, S&P and Moody's; Secure 4 is 'A–' from A.M. Best and 'A–' from Fitch, S&P and Moody's; Secure 5 is 'B++'/'B+' from A.M. Best and 'BBB+'/'BBB'/'BBB'-from Fitch, S&P and Moody's; and Vulnerable 6 or Unrated is any lower rating or reinsurers that are unrated.
27. The number of ratings that are required is not stated in the *NAIC Risk-Based Capital Forecasting & Instruction — Property/Casualty — 2015* document. However, Fitch notes that in the NAIC's Credit for *Reinsurance Model Law (# 785)*, two ratings are required.
28. To add a global perspective, it should be noted under Solvency 2 in the European Union, ceded reinsurance capital charges are based on a formula tied to probability of default (PD) and loss given default assumptions, where PD can be based on the ratings of over 25 designated CRAs. The equivalency table aligns the A.M. Best 'a' category Issuer Credit Rating (ICR), not the IFS rating, with the 'A' category IFS ratings of Fitch, Moody's and S&P. In its 2015 impairment study report, A.M. Best equates the 'a' category ICR with its 'A'/'A–' IFS ratings.

FOR MORE INFORMATION

While this white paper is primarily analytical in nature, certain ideas, such as views held by Fitch with respect to ratings users' potential realignments of their ratings equivalency standards (*Addressing the Differences*), or certain market implications of ratings shopping and the role of unsolicited ratings, are those of Fitch business personnel. Reader inquiries can be directed accordingly.

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