



Methodology

*Rating Canadian Property and Casualty
Insurance Companies*

MARCH 2011



Insight beyond the rating.

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All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, Web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.



Rating Canadian Property and Casualty Insurance Companies

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Introduction to DBRS Methodologies

- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations.
- The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.
- DBRS rating methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.
- As a framework, DBRS rating methodologies consist of several components that together form the basis of the ultimate ratings assigned to individual securities. Assessments typically include the industry's business risk profile, the company's general business risk profile, the company's financial risk profile and considerations related to the specific security.
- To some extent, the business risk and financial risk profiles are interrelated. The financial risk for a company must be considered along with the business risks that it faces. In most cases, an entity's business risk will carry more weight in the final issuer rating than will its financial risk.

Rating the Canadian Property and Casualty Insurance Industry

- The DBRS rating methodology for Canadian property and casualty (P&C) insurance companies applies primarily to regulated operating insurance companies and, by extension, to their respective insurance holding companies. Note that while DBRS rates primarily Canadian insurance groups, many of these companies have subsidiaries and affiliates with U.S. or international operations. The financial and operating performance of these affiliates in non-Canadian markets is equally important to the analysis of the group.
- While DBRS is primarily in the business of assigning ratings to debt and preferred shares for both operating insurance companies and their respective holding companies, the starting point for all DBRS ratings in this sector is the implied rating on the claims-paying ability of an operating insurance company. DBRS refers to this rating as the company's financial strength rating. As the senior-most insurance company obligation, the financial strength rating assesses an insurance company's probability of default.
- Derived from this rating are those assigned to the debt and capital obligations of the operating P&C insurance company, which rank below policyholder claims and whose ratings are generally notched down from the financial strength rating in line with each rated security's relative priority in liquidation.
- The ratings for the associated insurance holding companies follow the guidelines set out in the DBRS methodology *Rating Parent/Holding Companies and Their Subsidiaries*. The holding company's capital structure is assessed on an unconsolidated basis in order to better capture the impact of corporate structure, liquidity and double leverage on the rating of holding company obligations.



INDUSTRY STRUCTURE AND DEFINITIONS

- The Canadian P&C insurance industry is fragmented, with the top ten competitors representing about 60% of gross written premiums, according to 2009 data provided by the Office of the Superintendent of Financial Institutions (OSFI), the Canadian insurance industry regulator. The largest competitor has just 12% of the market. A notable feature of the Canadian P&C insurance market is that approximately 50% of all premiums are written by foreign-owned companies. Another 7% of premiums are written by insurance affiliates of the major Canadian chartered banks.
- DBRS provides ratings on companies whose subsidiaries account for approximately 37% of the gross written premiums in the Canadian P&C industry.
- Approximately 25% of the automobile insurance written in Canada is written by the provincially owned automobile insurance companies in British Columbia, Saskatchewan and Manitoba. More than 50% of all P&C insurance written is automobile-related risk; the percentage drops to 45% once the public insurance providers are excluded. The industry is equally split between personal and commercial lines of coverage.
- The ownership structure of the Canadian industry remains in flux, with some pressure for the industry to consolidate. Several foreign insurance companies have disposed of their Canadian insurance operations in order to repatriate capital in the wake of the 2008–2009 financial crisis. While a portion of the industry remains mutually owned, the consolidation trend can be expected to give rise to a move toward demutualization as companies require enhanced access to capital. This would be similar to the demutualization trend that occurred in the life insurance industry in the early part of the 21st century.
- The industry is mature given that product penetration is often mandated by third parties such as provincial legislatures (for automobile insurance) and lenders (for home insurance). Commercial lenders also require a minimum level of commercial P&C insurance coverage. Therefore, the growth rate for the industry is somewhat constrained to the broader macroeconomic growth rates.

The following broad industry factors suggest that the highest assigned financial strength rating for a P&C operating insurance company in Canada would be in the “A” range given the limited opportunities for diversification of risk exposures in a relatively concentrated geographic and jurisdictional market.

INDUSTRY PROFITABILITY AND CASH FLOW

- Earnings consist of underwriting profitability plus investment income. If a company’s underwriting profitability is marginal, reported earnings can be accounted for by investment income. Capital flows into the industry are complicated by the interest rate environment, which makes the collecting and investing of insurance premiums more or less attractive relative to the risk of having to pay out claims. This gives rise to the concept of cash flow underwriting, whereby an insurance operation becomes merely a vehicle by which to raise funds that can be invested in relatively risk-free investments. Low interest rates tend to discourage cash flow underwriting and put more emphasis on underwriting profitability.
- Like all insurance concerns, profitability is based on an educated guess as to the ultimate cost of the products provided, the actual cost of which will not be known for many years. Pricing insurance products so as to at least cover the expected cost of meeting policy obligations at some point in the future, including claims payments, loss adjustment expenses and administrative overhead, is referred to as underwriting profitability. As the actual loss experience develops, the insurance company may adjust its insurance reserves up or down to better reflect actual and expected loss experience, with a corresponding impact on reported underwriting profitability.
- Depending on a company’s underwriting expertise, these adjustments can potentially be large. With little ability to adjust pricing after the fact given the competitive market framework, consistency of underwriting profitability is the most important criteria for measuring the business risk of an operating insurance company.



- An additional contributor to insurance company earnings is investment income, which is the return earned on the accumulated insurance premiums prior to paying any policyholder claims. Each insurance company has a unique investment portfolio that is structured to maximize portfolio returns, subject to the expected requirements for liquidity, the timing of expected claims payments and regulatory capital. Therefore, the ability to manage investments so as to maximize returns is a complementary skill to underwriting and claims management and is subject to great variability among competitors.
- DBRS considers the inherent profitability of the Canadian P&C industry to be below average given the nature of underwriting risk, the fragmented industry, the commodity-type products and the lack of barriers to entry.

INDUSTRY COMPETITIVE LANDSCAPE

- Since the Canadian P&C industry is quite fragmented, with relatively low barriers to entry, there are often periods where product pricing is competitive, leading to weak underwriting profitability. This price competition is increased by the fact that the product is a commodity and easily shopped around.
- Within each company, different product lines are subject to more or less competition at any given point in time. In personal lines, government oversight with respect to automobile insurance pricing provides both a ceiling and a floor to market prices. In commercial lines, a large number of providers are tied into the global insurance and reinsurance industries, which takes the competitive framework out of the hands of the domestic industry.
- Generally, DBRS regards personal lines such as home and automobile insurance as having a more favourable competitive framework than commercial lines since they are less subject to the global insurance cycle and benefit from at least some regulatory oversight.

INDUSTRY STABILITY

- The Canadian P&C insurance industry is noted for the cyclicity of its earnings as it moves through alternating periods of hard and soft markets. This cyclicity in part reflects the low barriers to entry and the associated mobility of industry capital.
- Years of good financial performance cause capital to build up in the industry, which then puts downward pressure on premium rates, a period often referred to as a soft market. Ultimately, these falling premium rates are insufficient to cover the cost of insurance claims, which causes the industry to return to a hard market, characterized by firming premium rates, which in turn translates into higher earnings and a return to capital accumulation to start the cycle anew.
- The need for most insurance companies to manage risk exposures forces them to reinsure at least some of their risk. Therefore, Canadian insurance rates will reflect global reinsurance rates, which are vulnerable to catastrophic loss episodes related to weather and natural disasters, as well as to the flow of capital into the insurance industry on a world scale, which is, in turn, a function of the industry's relative profitability at any point in time.
- There are few barriers to entry in the extremely competitive and unregulated reinsurance industry, although minimum credit ratings are generally necessary.
- In rating an insurance company or an insurance holding company, DBRS will attempt to look through the insurance cycle so that cyclical industry conditions have no direct impact on the ratings assigned. The industry's earnings volatility is nevertheless responsible for keeping industry ratings below where they would otherwise be in a less cyclical industry.



INDUSTRY REGULATION

- The regulation of Canadian insurance companies by agencies of federal and provincial governments effectively governs the ability of these companies to remain going concerns. Adequate capital is mandated by regulators because the payment of insurance claims is made long after the premiums have been received.
- Regulatory capital is required to offset risks related to invested asset types and quality, underwriting risks, liabilities specific to the type of risk being underwritten and reinsurance counterparty exposures. The regulator compares the available capital with the required capital for each entity and determines whether it meets the required capital ratio thresholds.
- Insurance is also a highly regulated product, subject to political and legislative pressure. The regulation of automobile insurance, for example, has played a formative role in the Canadian P&C industry. Where private insurance is available, the regulators control premium rates and require that all drivers be insured, whether or not they are acceptable risks. Unacceptable risks are insured through the provincial Facility Associations, which are funded by the industry on a proportional basis.
- Insurance claims are also subject to the judicial interpretation of tort law, which can assign liability to insurers for which they had not originally priced their products. The industry regards regulatory risk as one of its most serious challenges and, therefore, supports the notional cap on company ratings.
- For most commercial insurance lines, customers expect their insurance underwriter to have a minimum financial strength rating provided by an independent rating agency. Therefore, the rating agencies also play a quasi-regulatory role in maintaining access to new insurance business.

OTHER INHERENT INDUSTRY CONSIDERATIONS

- P&C insurance product pricing is based on the same fundamental economic and actuarial principles that have governed insurance product pricing for hundreds of years. Enhanced computing power, however, has allowed those companies with more extensive databases to identify and articulate risks that otherwise would not be apparent through market segmentation. The scale and experience required to have the most thorough database will generally translate into more effective pricing and more consistent underwriting profitability.
- With such commoditized products, there is a marketing advantage in being able to respond quickly with quotes in real time. While this can maintain good relationships with distribution partners, it also makes the selling of insurance products through the competing direct channels more efficient and effective. However, given the history of selling insurance products through agents and brokers, facilitating the growth in direct channels represents a threat to a major stakeholder group in the industry.
- At the same time, there is more consolidation in the broker space on the horizon as the age of traditional insurance product distributors continues to increase. Dynamics in the distribution channels represent both challenges and opportunities to the insurance industry.



Company-Specific Business Risk Factors

In addition to analyzing the broad industry business risk factors outlined above, DBRS focuses on certain key drivers at the company level to accurately capture the essential strengths and challenges facing each company and provide transparency. The table below outlines what characteristics DBRS looks for in each rating category for the main company-level business risk factors.

Company-Specific Business Risks – Critical Factors

Rating	AA Exceptional	A Superior	BBB Adequate	BB Weak
Business Strength				
Market Presence and Scale	<ul style="list-style-type: none"> • Dominant market share in its chosen markets, supported by excellent brand awareness and effective scale in all products. • Chosen markets are large and inherently profitable given associated scale economies. • Market leader in terms of pricing and/or low-cost producer. 	<ul style="list-style-type: none"> • Enjoys a meaningful share of the market (5% to 10%) in chosen products given the fragmented market. • Long-time competitor in the industry, with recognized brands. • Grown to its current scale by following disciplined and proven business practices, including growth by successful acquisition and integration. 	<ul style="list-style-type: none"> • A significant competitor, with some market presence. • Some deficiencies in terms of brand awareness in significant markets and vulnerable to not maximizing scale economies. • Potentially a stronger presence in certain market niches. 	<ul style="list-style-type: none"> • Effective scale in specific but limited product lines. • Brand awareness is limited.
Distribution	<ul style="list-style-type: none"> • Multichannel distribution, including an effective and meaningful captive or direct distribution channel. • Attractive products that are in demand by third-party distributors as a result of retail customer demand and brand awareness. • Dominant in independent channel, reflecting financial strength and sophisticated IT platforms and interconnections. 	<ul style="list-style-type: none"> • Multichannel distribution, possibly including some captive distribution and direct channels. • Preferred provider for third-party distribution, with no concentration by broker. • Evolving customer service IT platform. 	<ul style="list-style-type: none"> • One or two third-party distribution channels or programs may account for a disproportionate share of new business. • Maintaining shelf space requires active wholesaling to insurance brokers and managing general agents (MGAs). • Risk of market share erosion and loss of popularity with third-party advisor channel. 	<ul style="list-style-type: none"> • Limited penetration of the third-party channel. • Limited alignment of product, customer and channel. • Vulnerable to any deterioration in market perception of financial strength. • Pure competition for shelf space. • Relies on cultivating individual advisors through intensive and expensive recruitment and solicitation.

Company-Specific Business Risks – Critical Factors

Rating	AA Exceptional	A Superior	BBB Adequate	BB Weak
Product and Market Diversification	<ul style="list-style-type: none"> Broad geographic diversification. Good market presence in both personal and commercial lines, with a good balance of risk exposures that are well underwritten, reflecting cumulative experience. Exposures to both reinsurance and insurance product underwriting. Market risks well managed and contained through active reinsurance programs. 	<ul style="list-style-type: none"> A diversified portfolio of products and geographical exposures, but modest concentration in specific product lines or geographies, which gives rise to risk exposures that may not be well underwritten or otherwise contained. Good risk management systems and underwriting processes in place. 	<ul style="list-style-type: none"> Some diversification, but with more concentration in some specific products and geographical markets. Generally, the diversification strategy is in its early stages, and correspondingly, the company has yet to hit the critical scale required to be a major competitor. Limited size and expertise may result in an inferior risk underwriting result. 	<ul style="list-style-type: none"> Limited product and market diversification, with only one or two major product lines accounting for the vast majority of sales, revenues and earnings. Risk exposures are assumed and not actively managed. Absence of strong underwriting disciplines.
Asset Quality and Management	<ul style="list-style-type: none"> A diversified, high-quality fixed-income portfolio that is appropriate to a short-tailed liability portfolio. 	<ul style="list-style-type: none"> High-quality fixed-income portfolio, but with higher concentrations of risky assets. 	<ul style="list-style-type: none"> Lower-quality fixed-income portfolio, reflecting a need for higher yields by virtue of product liabilities and pricing pressures. More indeterminate liabilities offset by riskier alternative assets. 	<ul style="list-style-type: none"> Higher exposure to BBB and lower bonds. Higher risky assets. Material non-investment-grade bond exposures and/or a higher weighting of risky assets.

MARKET PRESENCE AND SCALE

- The market position of an insurance company feeds into a number of earnings drivers in both the revenue and expense lines. In order to have a credible presence, a company must have cultivated its brand awareness through years of effective competition and building of trustworthiness. A history of trustworthiness generally translates into a meaningful market share, which in turn translates into brand awareness, ease of distribution and, ultimately, economies of scale.
- As in every industry, a recognizable brand in the P&C industry contributes greatly to franchise strength. Brands are generally established through market presence in the form of advertising as well as word of mouth.
- Because technology spending is also a source of significant scale economies, a larger company is expected to be a stronger credit. However, a smaller company with a specific product strength or niche may also enjoy advantageous pricing and distribution arrangements that support its financial performance and rating.
- A larger insurance company could potentially also be in possession of more data related to historical loss experiences with which to underwrite future insurance risks. With potentially stronger underwriting results, over time, the larger competitors become the price leaders and/or low-cost operators, with corresponding positive implications for profitability.
- Leveraging market and scale advantages into superior financial performance and internal capital generation better positions the company to compete more effectively and to withstand market volatility. A large equity base can provide additional comfort from one-time earnings hits, and larger firms often have more funding options in times of financial stress.

DISTRIBUTION

- P&C insurance companies distribute their products through a variety of channels, including independent brokers, exclusive agents and direct channels such as mail, affinity programs and the Internet. Within the independent broker category are smaller-scale mom-and-pop operations that tend to have a strong presence in specific locations, serving the insurance needs of a particular community.
- In contrast, large national managing general agents (MGAs) deal in complicated commercial risk programs, often charged with underwriting and pricing risks according to the insurance company's delegated criteria, which must correspondingly be monitored.
- No one distribution channel is regarded as being inherently superior to another. Each is employed to target a different customer segment with correspondingly different needs. A complicated commercial account, requiring multiple layers and categories of risk protection, will not be successfully served through a direct channel such as the Internet.
- Less sophisticated insurance customers are similarly more likely to take comfort from buying their insurance protection from someone who will advise them about the best product for them and who knows their personal circumstances, rather than purchasing a generic policy from an anonymous stranger over the telephone or the Internet, even if this alternative might be less expensive.
- It is important that, given its target customer base, the insurance company have the most effective distribution channel for that market. Correspondingly, a diversified distribution strategy generally complements a diversified market strategy.
- One of the most important criteria by which an insurance provider is chosen is how easy brokers, agents or insured customers find it is to do business with the provider in question. Ease of doing business is in turn measured by the ease of submitting insurance applications – which today means a user-friendly electronic interface – the speed with which quotes are provided and the responsiveness of the insurance company's claims management process.
- These performance metrics have traditionally been enhanced by spending on information technology. A strongly rated insurance company would be expected to excel in terms of technological interface.
- Except in those cases where the insurance company sells through its own exclusive agency sales force or provides very specific niche products to targeted customers, insurance companies are in broad competition with each other to win shelf space from independent brokers. Success in this capacity largely comes down to building relationships, which is generally a function of having well-priced, well-designed products and being easy to work with from an administrative perspective.
- It is important to note that the primary sales relationships in the insurance industry are between the company and the broker and the broker and the customer. With the exception of a growing direct sales effort in personal lines and the small and shrinking exclusive sales force channel, there is little relationship between the company itself and the ultimate customer.

PRODUCT AND MARKET DIVERSIFICATION

- P&C insurance companies describe their business as being either personal lines or commercial lines. Personal lines include automobile and property protection policies. In Canada, personal automobile insurance is generally regulated by the provincial financial services authorities in those markets where it is not supplied by government agencies (Alberta, Ontario and the Maritime provinces). In Québec, personal automobile insurance is offered by the private sector for collision coverage only, with liability and bodily injury coverage provided by the government on a no-fault basis.
- Commercial lines consist of both property and casualty coverage on workplaces, commercial property and equipment, and automobile and truck fleets, with the accompanying general liability coverage, as well as specialized niche products. Some Canadian insurance companies also provide reinsurance products as either third parties or as captives to their own insurance operations, most often based in tax-advantaged offshore locations.
- Personal lines involve generally short-tailed insurance risks such as those that result from accidents and natural occurrences. Aside from the occasional episode of bad weather or catastrophic loss, claims related to personal lines are generally predictable, quickly settled and adequately priced into the product.



- The greatest source of uncertainty in this line of business is often the regulator, which must approve automobile insurance rates and is subject to political considerations. Certain automobile insurance jurisdictions with inadequate regulatory frameworks can suffer serious losses before the regulator acts to restore the industry's financial health and sustainability.
- Catastrophic events can also hurt insurance company financial performance, especially if an effective reinsurance program has not been put in place. DBRS is aware that changing environmental conditions are a growing source of concern to insurance companies and have the potential to increase the frequency and severity of natural catastrophes.
- Commercial lines are generally unregulated and, because of the relatively large size of individual claims, are more exposed to the global insurance market through the insurance company's need to reduce its larger overall risk exposures through the purchase of reinsurance from global providers. As such, the market for commercial lines is distinctly more cyclical than that for personal lines.
- Moreover, commercial risks can involve casualty or general liability risks such as product or environmental liability, which can be long-tailed risks that may only be recognized and settled after many years of litigation. This exposes the insurance company to greater claim uncertainty, including the cumulative effects of inflation.
- All other things being equal, a company with a concentration in personal lines, which have lower income volatility, is likely to be more highly rated than one with a concentration in commercial lines, even though commercial insurance could prove to be more profitable over time. This does not, however, alter the strategic advantage of having a diversified portfolio of risks and business lines.

ASSET QUALITY AND MANAGEMENT

Investment Portfolio

- The investment portfolio of a P&C company is generally invested in highly liquid and conservative fixed income securities. The duration of the assets in the portfolio is generally fixed at a term that optimizes investment income without impairing the liquidity of the portfolio. There are few asset liability management (ALM) considerations.
- Certain insurance companies actively manage their investment portfolios, whereas others outsource their investment management. For some active investment managers, writing insurance premiums is little more than a source of investable funds, or "float," with investment management capability being the key source of added value.
- DBRS does not necessarily favour one approach over the other but does expect that each company is mindful of its assumed level of investment risks and liquidity requirements given the expected payout on claims. In addition, a larger component of the self-managed portfolio can be made up of strategic investments, which generally adds to the volatility of the realized investment gains income item.
- An effective investment management operation is characterized by appropriate risk management controls, including investment policy statements, operational authority limits, and monitoring and reporting procedures. DBRS assesses a company's general compliance with its approved investment policies.

Reinsurance Recoverables

- In order to limit its risk exposures and most efficiently manage its capital, P&C insurance companies often purchase reinsurance. This gives rise to exposures to reinsurance company counterparty risk. DBRS monitors the level of reinsurance recoverables relative to common equity and in terms of the overall quality of the reinsurance counterparties.
- DBRS reviews reinsurance counterparty exposure for each insurance company by reviewing its reinsurance programs, the size of its exposure to reinsurance counterparties, the quality of those reinsurance counterparties and any available collateral supporting their obligations.



COMMON BUSINESS CONSIDERATIONS

- There are two major considerations that were not included with the prior analysis but can have a meaningful impact on an individual company in any industry: country risk and corporate governance (which includes management). These areas tend to be regarded more as potential negative issues that could result in a lower rating than otherwise would be the case, although DBRS would certainly consider exceptional strength in corporate governance as a rating attribute.
- In most cases, our focus on the two areas is to ensure that the company in question does not have any meaningful challenges that are not readily identifiable when reviewing the other business risk considerations and financial metrics outlined in this methodology.

Country Risk

- Governments often intervene in their economies and occasionally make substantial changes that can significantly affect a company's ability to meet its financial obligations; therefore, considerations include the company's main location or country of operation, the extent of government intervention and support and the degree of economic and political stability.
- As such, the sovereign rating itself may in some cases become a limiting factor in an entity's rating, particularly when the sovereign has a lower rating and the entity does not have meaningful diversification outside its domestic economy.
- With respect to the P&C insurance industry, the regulatory framework is generally accommodative. DBRS assumes that the industry has no strategic value to the national or provincial economies that might result in the industry being the beneficiary of specific or systemic financial support from the governing bodies or regulators.

Corporate Governance

- Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no single approach that will be optimal for all companies.
- A good board will have a profound impact on a company, particularly when there are significant changes, challenges or major decisions facing the company. DBRS will typically assess factors such as the appropriateness of board composition and structure, opportunities for management self-interest, the extent of financial and non-financial disclosure and the strength or weakness of control functions. For more detail on this subject, please refer to the DBRS criteria *Evaluating Corporate Governance*.
- With respect to the pivotal area of management, an objective profile can be obtained by assessing the following: the appropriateness of core strategies; the rigour of key policies, processes and practices; management's reaction to problem situations; the integrity of company business and regulatory dealings; the entity's appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles can also be considerations.
- In the P&C insurance industry, there are three relatively distinct corporate cultures determined largely by the industry experience and training of the senior management teams: marketing, risk underwriting and investments. While each culture is equally capable of producing a successful insurance organization, each manifests itself differently in the operations and corresponding risk profile of the rated companies.
- Because insurance companies are acknowledged experts in the management of specific claim risks, DBRS has especially high expectations that there will be an explicit framework governing the appetite, recognition, assessment, evaluation and mitigation of risk at an enterprise level, including operating risks that have historically been a source of losses for P&C companies.
- DBRS expects insurance claims reserves and unearned premiums reserves to be established using conservative, independent actuarial estimates. A measure of conservatism is whether or not excess reserves are released into income over time. Alternatively, a pattern of having to increase reserves on account of the pre-existing book of business is generally regarded unfavourably.



Company-Specific Financial Risk Factors

KEY METRICS

- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our key metrics to a small universe of critical ratios. For each of these ratios, DBRS provides a range within which the issuer's financial strength would be considered as supportive for the same level of business risk as the P&C insurance industry. For example, a company where the outlook for both business risk and financial risk metrics falls within the BBB category would, all else being equal, be expected to have an issuer rating in the BBB range.
- To be clear, the ratings in the matrix below should not be understood as the final rating for an entity with matching metrics. This would only be the case to the extent that the business risk of the company and a wide range of other financial metrics were also supportive. The final rating is a blend of both the business risk and financial risk considerations in their entirety.

Property and Casualty Insurance Industry Financial Metrics

Key Ratio	AA	A	BBB	BB
Combined ratio (five-year average)	< 92.5%	92.5% to 97.5%	97.5% to 100%	> 100%
Return on equity (five-year average)	> 15%	10% to 15%	5% to 10%	< 5%
Debt plus preferred shares-to-capitalization (consolidated)*	< 15%	15% to 25%	25% to 35%	35% to 45%
EBIT fixed charge coverage (five-year average consolidated)*	> 10.0x	7.0x to 10.0x	5.0x to 7.0x	3.0x to 5.0x
Minimum capital test (MCT) ratio (major operating companies)	> 200%	> 200%	> 200%	< 200%

* Assumes a mature capital structure at the holding company.

- While the data in the above table are recognized as key factors, they should not be expected to be fully adequate to provide a final financial risk rating for any company. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be limited to a finite number of metrics, regardless of how critical these may be.
- DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS's opinion on future metrics, a subjective but critical consideration.
- It is also not uncommon for a company's key ratios to move in and out of the ranges noted in the ratio matrix above, particularly for cyclical industries. In the application of this matrix, however, DBRS is typically focusing on multi-year ratio averages.
- Notwithstanding these potential limitations, the key ratios are very useful in providing a good starting point in assessing a company's financial risk.
- It is important to note that actual financial ratios for an entity can and will be influenced by both accounting and accounting choices. In Canada, this will include the shift to International Financial Reporting Standards (IFRS). DBRS acknowledges that IFRS and other accounting choices will have an impact on the financial metrics of the companies that it covers. The financial risk factors include ratios based on data from company financial statements that are based on Canadian Generally Accepted Accounting Principles (GAAP) and U.S. GAAP, for the most part. When company financial statements are based on GAAP in other countries, including IFRS, the ratios and ranges may need to be redefined.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS examines when evaluating the financial risk profile of a company, the following provides a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.

Overall Considerations in Evaluating a Company's Financial Risk Profile

In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis for the P&C insurance industry. As it is not possible to completely separate business and financial risks, note that many of the following ratios will relate to both areas.

EARNINGS

Earnings are the primary source of new capital for an insurance company. Correspondingly, a profitable insurance company not only reflects good underwriting discipline but is also better prepared to finance its organic growth and support its capital adequacy.

Underwriting Results

- Against a cyclical industry background, an insurance company measures its core profitability by its combined ratio, which is the sum of two ratios: the loss ratio and the expense ratio. An insurance company's loss ratio reflects its claims payments, its loss adjustment expenses and its actuarial reserve development for anticipated claims, based on current cases and incurred but not yet reported (IBNR) cases as a percentage of its earned premiums.
- The expense ratio represents administrative expenses and distribution costs as a percentage of net written premiums (although some companies measure expenses against earned premiums), which reflects new business being written. If the combined ratio is less than 100%, the insurance company can be said to have earned an underwriting profit for the period. This means that the company allocated less to the amount of claims, expenses and claims reserves than it received in insurance premiums. Therefore, the main challenge for an insurance company is to price its products so that its premiums income is sufficient to cover its actual claims costs over time. These claims can only be estimated, which adds an element of uncertainty to reported financial results.
- An insurance company will often choose not to price at the market if it feels that it can not make money at soft prices. Therefore, the top line, or net premiums written, will drop. This can have the impact of increasing the expense ratio, but generally DBRS regards such pricing discipline favourably.
- For analytical clarity, DBRS also looks at the combined ratio on an accident-year basis. Because claims and reserve development often occur over time, it is important to attribute such claims costs correctly to the accident years to which they rightfully pertain. In this way, the true cost of underwriting is assessed over time.
- For example, a company with a plan to improve underwriting performance can thereby show its progress unsullied by the residual losses related to earlier underwriting periods reflected in current results. A downward trend in accident-year combined ratios, while not necessarily reflecting the development of reported profitability, does reflect important shifts in the underlying effectiveness of the company's underwriting.
- The success of the insurance industry is built on the concept of risk pooling. Within each class of risk, having many insured risks will generally ensure that no one event results in a claim affecting all of them at once. However, weather-related events often result in multiple claims from the same geographic region – a phenomenon that the industry anticipates will only get worse.
- It is, therefore, increasingly important to maintain a diversified portfolio of risk exposures both geographically and by type, while remaining within the underwriting capability of the company. DBRS monitors the diversification of each related group of companies' risk exposures by type and geography. A highly rated insurance company would be expected to have a well-diversified risk portfolio so that it is not vulnerable to a single risk event. However, to achieve the critical scale in each of these market segments, it follows that a well-diversified risk portfolio is most consistent with a very large insurance company. Even the largest insurance company in Canada is small relative to a truly diversified global competitor and accordingly would have difficulty achieving the highest rating for the sector.

Investment Income

- Beyond underwriting results, which may or may not be profitable, insurance companies invest the excess of written premiums over claims paid in generally high-quality investments, although each company will have its own relative weighting in different asset classes such as cash, bonds and equities. The successful investment of this positive “float” is the fundamental basis of many insurance companies’ strategic business models.
- Investment returns take several forms. Current income is earned through interest on fixed income investments and dividends earned on preferred and common share investments. This return can be expressed as a current yield on the company’s investment portfolio and tracked for reasonableness. Realized gains on equity investments are a more volatile component of investment income and can be substantial. DBRS tracks financial margins, both including and excluding realized gains, to maintain comparability since there can be no predictability to realized gains.
- Sound investment decisions are inevitably important to the long-term financial performance of an insurance company. However, it is also important that the earnings primarily reflect underwriting and stable returns on conservative investments in fixed income securities and that less weight be given to discretionary investment income such as realized gains.

Return on Equity

- The resulting financial performance of the company is best expressed as the core return on shareholders’ equity (ROE), excluding non-recurring items. ROE is an effective measure of both profitability and efficient capital utilization.
- The industry average ROE tends to be volatile over the life of the insurance industry cycle, with targets in the 10% to 15% range. Holding company ROE is also volatile, given that most holding companies also have some financial leverage as a result of having made debt-financed acquisitions of operating subsidiaries.

Typical Earnings Ratios

- Return on common equity.
- EBIT margin.
- Loss ratio.
- Expense ratio.
- Combined ratio.
- Accident-year combined ratio.
- (Development)/redundancy ratio.
- Total investment return.
- Total realized return.
- Current income yield.
- Realized gains-to-total investment income.

FINANCIAL LEVERAGE

- As operating insurance companies are generally not permitted to issue debt (OSFI limits debt of a regulated general insurance company to 2% of regulatory capitalization), most general insurance groups employ financial leverage at the holding company level. Ratios of debt and debt plus preferred shares-to-total capital give a sense of the holding company’s use of financial leverage.
- Where hybrid securities or preferred shares might be used as a form of capital, the specific terms of each instrument must be weighed in order to assign a respective debt weighting that is incorporated into the DBRS-adjusted debt-to-capital ratio. This treatment follows from the published DBRS methodology *DBRS Preferred Share and Hybrid Criteria for Corporate Issuers (Excluding Financial Institutions)*.
- DBRS attempts to measure the ability of the insurance company to service its debt and preferred share obligations over the insurance cycle to diffuse the impact of underwriting cycles and investment gains and losses. The holding company issuer must rely on the upstream flow of dividends or interest payments to service its own fixed income obligations. Interest and fixed charge coverage ratios capture the company’s ability to service its financial obligations.



- To the degree that a holding company has available cash resources in the form of unencumbered investments or additional debt capacity in the form of credit lines or capital market access, financial flexibility is enhanced and is reflected in the rating. Where an insurance company continues to adhere to the mutual ownership model, DBRS would expect a more conservative capital structure, reflecting reduced access to equity capital markets.
- The incurrence of debt at the holding company to provide equity capital to operating subsidiaries creates double leverage, the use of which should be limited in order to earn the highest possible rating. The analysis of double leverage requires a review of the unconsolidated financial statements of the holding company, which are generally not in the public domain.

Typical Financial Leverage Ratios

- Assets-to-equity.
- Debt-to-capitalization.
- Debt plus preferred shares-to-capitalization.
- Net debt plus preferred shares-to-capitalization.
- Debt service coverage ratio.
- Debt service coverage ratio (before investment gains).

CAPITAL ADEQUACY

Static Portfolio Analysis

- An insurance company's capital adequacy is one of the most important quantitative measures of its financial health and its ongoing ability to meet its liabilities to pay claims. Both regulators and DBRS tend to focus on this measure in monitoring the financial strength of insurance companies.
- Regulators generally employ a factor model that assigns different capital factors to certain classes of risk exposures and assets. For example, a different factor is attached to each risk, with higher-quality assets requiring a lower capital charge, with unearned premiums and unpaid claims in different product lines assigned different factors depending on historical volatility of earnings and claims in those lines of business, catastrophic reserve exposures and reinsurance counterparty exposure (i.e., exposure to reinsurance recoverables from both a credit and an actuarial perspective).
- Regulators measure capital adequacy by comparing required capital calculated by the factor model with the company's available capital, which is scaled in importance and relevance, depending on its degree of permanence, subordination and whether it bears a mandatory debt service payment.
- DBRS recognizes that capital adequacy is an important, albeit static, measure of financial health for an insurance company. DBRS focuses on the factor models employed by the financial services regulators inasmuch as the solvency of an insurance company is ultimately determined by the regulator. Consequently, DBRS incorporates regulatory capital adequacy benchmarks as part of its credit analysis without attempting to re-create a capital adequacy model using either a stochastic or deterministic basis.
- OSFI calculates a minimum capital test (MCT) for each regulated insurance company that is expected to be at least 150% coverage of required capital with available capital, including equity, preferred shares and subordinated debt, less goodwill. Under the MCT framework, the incremental 50% in excess of 100% coverage is expected to cover risk exposures otherwise not measured by the factor model, such as market volatility and operational and business risks.
- DBRS would generally expect an investment-grade operating insurance company to maintain an MCT ratio of at least 200%, although capital adequacy is only one of many criteria that factor into a rating opinion.
- Most financial institutions and regulators are presently developing deterministic-stochastic prediction models for the purpose of assessing capital adequacy. Economic capital models draw on stochastic models similar to those used in structuring and rating securitization transactions. These stochastic models simulate multiple economic scenarios to create a distribution of possible loss experiences.
- Within these models is the ability to incorporate the advantages of risk diversification, which may in fact lower required capital. DBRS will continue to monitor the development of company economic capital models and incorporate the results into its own capital adequacy assessment, having reviewed the models for reasonableness.



Capacity Ratios

- Another relevant aspect of capital adequacy for a P&C insurance company is that having capital increases the capacity for writing new business. There are operating guidelines in the industry that limit the amount of new premiums that can or should be written relative to existing capital or surplus, thereby limiting the ability of an insurance company to overextend itself. The higher the amount of premiums written on a fixed amount of surplus corresponds to a higher probability of incurring an underwriting loss.
- DBRS generally believes that annual new premiums should not be written in excess of two times capital and surplus. Other measures of capital adequacy include the ratio of insurance liabilities to surplus and capital, which measures the degree to which capital is exposed to on-balance-sheet insurance risks. Reinsurance exposure is also measured relative to surplus and common equity.

Typical Capital Adequacy Ratios

- MCT ratio.
- Excess capital.
- Net written premiums-to-statutory surplus.
- Reinsurance recoverables-to-surplus.
- Claims provision-to-surplus.

LIQUIDITY

- Insurance operating companies pay claims out of received premiums, with the excess cash being invested, generally in high-quality liquid securities. As long as an insurance company is writing new business, it is quite possible that the investment portfolio will continue to grow.
- Only when claims payments spike is it likely that investments will have to be liquidated to meet policyholder obligations. In this event, it is important that there be a measurable degree of liquidity in the insurance company's investment portfolio.
- Such portfolio liquidity is generally consistent with most insurance companies' desire to take most of their risk on the liability side of the balance sheet. It is not generally expected that an operating P&C insurance company will try to match the term of its assets and liabilities as a life insurance company would since the operating assumption is that most claims will pay out in relatively short order. This, however, removes an active constraint on a company's investment portfolio and can result in more aggressive portfolio management.
- At the holding company level, the concern for liquidity is greater since holding company obligations can generally only be served through the receipt of dividends from its regulated subsidiaries. Dividends paid to the holding company are implicitly subject to the approval of the regulator, which determines each operating company's capital adequacy.
- A more diversified holding company portfolio that includes unregulated operating subsidiaries and alternative sources of liquidity – such as an unencumbered investment portfolio – will generally be regarded favourably in the rating decision. Correspondingly, DBRS will want to be comfortable that the holding company's dividend policy is set prudently, subject to the potential volatility of earnings from the insurance operations. Excess regulatory capital at the operating company level is a proxy for upstream dividend potential.

Typical Liquidity Ratios

- Net increase in cash and investments.
- Holding company liquidity plus excess regulatory capital.
- Invested assets-to-total assets.

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