Methodology

Rating Companies in the Canadian Life and Health Insurance Industry

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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 Companies in the Canadian Life and Health Insurance Industry

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Scope and Limitations

This methodology represents the current DBRS approach for ratings in the life and health insurance industry. It describes the DBRS approach to credit analysis, which includes consideration of historical and expected business and financial risk factors as well as industry-specific issues, regional nuances and other subjective factors and intangible considerations. Our approach incorporates a combination of both quantitative and qualitative factors. The methods described herein may not be applicable in all cases; the considerations outlined in DBRS methodologies are not exhaustive, and the relative importance of any specific consideration can vary by issuer. In certain cases, a major strength can compensate for a weakness and, conversely, a single weakness can override major strengths of the issuer in other areas. DBRS may use, and appropriately weight, several methodologies when rating issuers that are involved in multiple business lines. Further, this methodology is meant to provide guidance regarding the DBRS methods used in the sector and should not be interpreted with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Introduction to DBRS Methodologies

- DBRS publishes rating methodologies to give issuers and investors insight into the rationale behind DBRS's rating opinions.
- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. DBRS ratings assess an issuer’s ability to make timely payments on outstanding obligations (whether principal, interest, preferred share dividends or distributions) with respect to the terms of an obligation. In some cases (e.g., non-investment grade corporate issuers), DBRS ratings may also address recovery prospects for a specific instrument given the assumption of an issuer default.
- DBRS operates with a stable rating philosophy; in other words, DBRS strives to factor the impact of a cyclical economic environment into its ratings wherever possible, which minimizes rating changes due to economic cycles. Rating revisions do occur, however, when more structural changes, either positive or negative, have occurred, or appear likely to occur in the near future.
- DBRS also publishes criteria that are an important part of the rating process. Criteria typically cover areas that apply to more than one industry. Both methodologies and criteria are publicly available on the DBRS website, and many criteria are listed below under “Rating the Specific Instrument and Other Criteria.”
The DBRS Canadian life and health insurance industry methodology applies primarily to regulated operating insurance companies and, by extension, to their respective insurance holding companies. These companies may have subsidiaries and affiliates with U.S. or international operations. Where these international affiliates are material, the financial and operating performance of these affiliates in non-Canadian markets is important to the analysis of the group.

While DBRS assigns 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 (which uses the DBRS Claims Paying Ability Rating Scale) as the company’s financial strength rating. As the senior-most insurance company obligation, the financial strength rating assesses an insurance company’s ability to meet its most senior claims. Related to this rating are those published ratings that are assigned to the debt and capital obligations of the operating life insurance company, which rank below policyholder claims.

The ratings for the associated insurance holding companies follow the guidelines set out in the DBRS methodology Rating 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**

The Canadian life and health (life) insurance industry is relatively concentrated, with three large competitors in the Canadian market. Several Canadian life insurance companies have an international presence, operating in markets such as the United States, Europe and Asia. The ownership structure of the industry comprises stock, mutual, fraternal and co-operative insurance companies. Products offered are diverse, including individual, affinity and group or employee plans offering life, health and disability insurance, savings, annuities and investment products.

**INDUSTRY REGULATION**

The regulation of Canadian insurance companies is conducted by agencies of federal and provincial governments. Regulatory capital is required by the Office of the Superintendent of Financial Institutions (OSFI) and its provincial counterparts to offset risks related to asset quality, mortality/morbidity, interest rates and equity markets, etc. The credit evaluation of insurance-related holding companies considers the diversity of sourcing funds for meeting holding company financial obligations and will include an evaluation of the potential regulatory restrictions on dividend payments by the operating insurance companies.
Canadian Life and Health Insurance Business Risk Rating

PRIMARY BRR FACTORS

- The business risk rating (BRR) grid below shows the primary factors used by DBRS in determining the BRR. While these primary factors are shown in general order of importance, depending on a specific issuer’s business activities, this ranking can vary by issuer.
- For further information on the meaning of ICI-1 through ICI-4 in the headings of the table below, refer to Claims Paying Ability Rating Scale in the rating scales section of DBRS’s website.

<table>
<thead>
<tr>
<th>Rating</th>
<th>AAA/AA/IC-1/IC-2</th>
<th>A/IC-2</th>
<th>BBB/IC-3</th>
<th>BB/IC-4</th>
</tr>
</thead>
</table>
| Market Presence and Scale | Material market share in its chosen markets, supported by excellent brand awareness and effective scale in all products.  
• Chosen markets are large and inherently profitable.  
• Market leader in terms of pricing and product offerings. | A significant competitor, with good market presence.  
• Maximizes potential economies of scale.  
• Probably a long-time competitor in the industry. | Some deficiencies in terms of brand awareness in significant markets and vulnerable to not maximizing scale economies.  
• Effectively, the company must work harder and spend more to maintain market share. | Effective scale in specific, but limited, product lines.  
• While market share is being maintained in certain lines, overall share is threatened by limited brand awareness. |
| Distribution  | Diversified distribution channels, possibly including effective captive distribution channel, where the company can directly control the sale of its products.  
• Attractive products that are in demand by third-party distributors as a result of retail customer demand and awareness.  
• Dominant shelf presence in independent channel. | Effective competitor for third-party distribution, with no concentration by broker but exposed to competition for shelf space.  
• May also have some captive or direct distribution. | One or two third-party distribution channels may account for a disproportionate share of business.  
• Constant risk of market share erosion and loss of popularity with third-party advisor channel. | 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. |
| Product and Market Diversification | Characterized by broad product and geographical diversification.  
• Good market presence in both protection and wealth accumulation products.  
• Good cross-selling opportunities. | A well-diversified portfolio of products and geographical exposures, with some concentration in specific product lines.  
• Some concentration in geographical or jurisdictional exposures where the company has an established market presence. | More concentration in some specific products and 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 product and market diversification, with only one or two major product lines accounting for the vast majority of sales, revenues and earnings. |
### Canadian Life and Health Insurance — Primary BRR Factors

<table>
<thead>
<tr>
<th>Rating</th>
<th>AAA/AA/IC-1/IC-2</th>
<th>A/IC-2</th>
<th>BBB/IC-3</th>
<th>BB/IC-4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Management</strong></td>
<td>Established and effective risk policies and procedures, appropriate reporting lines and a near flawless execution history of managing the risks.</td>
<td>Well-established risk policies and procedures, appropriate reporting lines and some execution issues in managing the risks.</td>
<td>Adequate risk policies and procedures, appropriate reporting lines and an adequate level of execution managing the risks.</td>
<td>Basic risk policies and procedures, weak reporting lines and a poor execution record of managing the risks assumed by the company.</td>
</tr>
<tr>
<td>• And/or a product portfolio that has very minimal liquidity and balance sheet risks.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Underwriting Experience</strong></td>
<td>Conservative underwriting record and very few, if any, examples of underwriting errors or adverse selection.</td>
<td>More innovative product design, albeit offset by some adverse historical experience in certain products.</td>
<td>Inconsistent underwriting profits aggravated by a lack of product diversification.</td>
<td>Unsatisfactory underwriting results due to pricing competition or fundamental lack of understanding of product risks.</td>
</tr>
<tr>
<td>• Superior risk management framework giving rise to consistent underwriting profitability.</td>
<td>• More volatile underwriting income, possibly reflecting a less seasoned or sophisticated risk management framework.</td>
<td>• Possibly less rigorous approach to risk management.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Investment Risk and Asset Quality</strong></td>
<td>A diversified, high-quality fixed-income portfolio that is appropriate to a low-risk liability portfolio.</td>
<td>Good-quality fixed-income portfolio, with possibly higher concentrations of riskier alternative assets to hedge more indeterminate liabilities.</td>
<td>Lower-quality fixed-income portfolio, reflecting a need for higher yields by virtue of product liabilities and pricing pressures.</td>
<td>Higher BBB-rated exposures and lower bond exposures, less strict ALM and higher-risk assets.</td>
</tr>
<tr>
<td>• Good asset-liability management (ALM), with tight duration and cash flow matching.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The following BRR risk factors are relevant to issuers in all industries (although the relevance of sovereign risk can vary considerably):

**Sovereign Risk**
The issuer rating may, in some cases, be constrained by the credit risk of the sovereign; in other words, the rating of the country in which the issuer operates generally sets a maximum rating for the issuer. If the issuer operates in multiple countries and a material amount of its business is conducted in a lower-rated country, DBRS may reflect this risk by downwardly adjusting its issuer rating.

**Corporate Governance**
Please refer to DBRS Criteria: Evaluating Corporate Governance for further information on how DBRS evaluates corporate governance and management.

### Market Presence and Scale
- Sufficient presence and scale can provide competitive advantages in areas such as cost and operational efficiency, supply discounts, market profile and customer perception. Effective scale in the life insurance industry is increasingly important, as sophisticated information systems reduce the per-unit cost of underwriting and selling complex financial products through chosen distribution channels. By lowering per-unit costs and enhancing customer service, a company can potentially increase its margins and pricing power while maintaining relationships with customers and distributors and enhancing cross-selling opportunities.
- 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.
Distribution

- Life insurance companies have a variety of distribution models from which to choose, including the exclusive agency sales force, the independent financial advisor or broker and the direct channel.
- DBRS regards the traditional exclusive agency distribution channel as having strengths in terms of customer retention, cross-selling potential and maintaining distribution stability. However, this channel tends to be expensive to maintain.
- The ability of the life insurance company to maintain a competitive position in competing directly with and/or supplying products to other financial institutions that control important distribution channels (e.g., bank-owned brokerages) will be considered in the assessment.

Product and Market Diversification

- A highly rated insurance company is expected to be diversified by product and by geography.
- Across geographical or political jurisdictions, each company is also exposed to changes in regulation, economic conditions and the relative sophistication of the insurance product markets. A diversified portfolio of products and markets should reduce the volatility of consolidated earnings while also providing the opportunity to rebalance products and market exposures to better manage risk and optimize the use of capital.
- A company with a diversity of products in each of life and health can better service the client’s changing life cycle needs and be able to respond to changing market conditions in a way that favours the sale of certain products versus others.

Risk Management

- DBRS’s review of the risk management policies and procedures of the life insurance company includes an evaluation of the company’s level of risk tolerance and the monitoring and compliance exercises performed by the company. A company with an effective risk management framework that has demonstrated the ability to prudently manage risks would be considered lower credit risk and will have stronger, less volatile long-term financial performance.
- A life insurance company is expected to have an explicit framework governing the appetite, recognition, assessment, evaluation and mitigation of the risks it faces, including mortality, morbidity and persistency risks; market and interest rate risks; credit risk; and strategic and operational risks.

Underwriting Experience

- Because the inherent profitability of insurance products is only realized with the passage of time, the ability to underwrite long-tailed risk and price it to generate acceptable levels of profitability is a critical business factor. Some insurance companies tend to be at the leading edge of product development, which can give rise to strong new sales in the short run, but if pricing does not capture the associated risk appropriately, it could result in reduced profitability in the longer term.
- Underwriting experience is usually assessed as part of a broader risk management framework. A conservative, well-seasoned and integrated risk management platform is expected to prevent, or at least limit, the occurrence of underwriting losses and dramatic changes to policy liability reserves due to business experience factors, which may include mortality, morbidity, lapses, policyholder behaviour and investment returns, etc. Less prudent risk management is therefore associated with lower-rated credits.

Investment Risk and Asset Quality

- In analyzing the investment portfolio of a life insurance company, DBRS is primarily concerned with the asset mix of the overall portfolio and how that mix might expose the company’s financial performance to the movements of the broader capital markets.
- The company’s mix of asset classes should reflect the features of the corresponding liabilities. Each class of investment asset must achieve satisfactory levels of diversification by geography, industrial sector and specific credit exposure. Some companies take on more credit and/or illiquidity risk, which generally requires sophisticated credit management processes and controls.
• The company’s average credit rating for its bond portfolio — as well as the company’s relative exposure to lower-quality assets, such as BBB-rated or non-investment-grade credits — is monitored as a measure of credit risk tolerance (see the Canadian Life and Health Insurance Financial Risk Rating section below).

• 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.

### Canadian Life and Health Insurance Financial Risk Rating

#### PRIMARY FRR METRICS

• The financial risk rating (FRR) grid below shows the primary FRR metrics used by DBRS to determine the FRR. While these primary FRR metrics are shown in general order of importance, depending upon an issuer’s activities, the ranking can vary by issuer.

• DBRS ratings are primarily based 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 not unusual for a company’s metrics to move in and out of the ranges noted in the grid below, particularly for cyclical industries. In the application of this matrix, DBRS looks beyond the point-in-time ratio.

• Financial metrics depend on accounting data whose governing principles vary by jurisdiction and, in some cases, industry. DBRS may adjust financial statements to permit comparisons with issuers using different accounting principles.

• Please refer to DBRS Criteria: Financial Ratios and Accounting Treatments — Non Financial Companies for definitions of, and common adjustments to, these ratios in the FRR grid below.

• Liquidity can be a material risk factor, especially for lower-rated non-investment-grade issuers. DBRS will consider available sources of liquidity, including cash on hand, cash flow, access to bank lines, etc., as well as uses of liquidity such as operations, capital expenditures, share buybacks and dividends for every issuer.

• While market pricing information (such as market capitalization or credit spreads) may on occasion be of interest to DBRS, particularly where it suggests that an issuer may have difficulty in raising capital, this information does not usually play a material role in DBRS’s more fundamental approach to assessing credit risk.

#### Canadian Life and Health Insurance Financial Risk Rating — Primary FRR Metrics

<table>
<thead>
<tr>
<th>Primary Metric</th>
<th>AAA/AA/IC-1/IC-2</th>
<th>A/IC-2</th>
<th>BBB/IC-3</th>
<th>BB/IC-4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum continuing capital and surplus requirements (MCCSR) (major operating company)</td>
<td>&gt; 175%</td>
<td>&gt; 175%</td>
<td>&gt; 175%</td>
<td>&lt; 175%</td>
</tr>
<tr>
<td>Tier 1 MCCSR (major operating company)</td>
<td>&gt; 120%</td>
<td>&gt; 120%</td>
<td>&gt; 120%</td>
<td>&lt; 120%</td>
</tr>
<tr>
<td>Return on equity (consolidated)</td>
<td>&gt; 15%</td>
<td>10% to 15%</td>
<td>5% to 10%</td>
<td>&lt; 5%</td>
</tr>
<tr>
<td>EBIT fixed-charge coverage (consolidated)</td>
<td>&gt; 7.0x</td>
<td>5.0x to 7.0x</td>
<td>3.0x to 5.0x</td>
<td>&lt; 3.0x</td>
</tr>
<tr>
<td>Debt plus hybrids plus preferreds-to-capitalization (consolidated)</td>
<td>&lt; 25%</td>
<td>25% to 35%</td>
<td>35% to 45%</td>
<td>&gt; 45%</td>
</tr>
<tr>
<td>Assets-to-equity (consolidated)</td>
<td>&lt; 6.0x</td>
<td>6.0x to 8.0x</td>
<td>8.0x to 10.0x</td>
<td>&gt; 10.0x</td>
</tr>
<tr>
<td>BBB- and lower-rated bonds and mortgages</td>
<td>&lt; 20%</td>
<td>20% to 30%</td>
<td>30% to 40%</td>
<td>&gt; 40%</td>
</tr>
</tbody>
</table>
**Regulatory Capital Adequacy**

- Risk-adjusted capital adequacy is one of the most important quantitative measures of a life insurance operating company’s overall financial health and its ability to continue to meet its obligations.
- DBRS incorporates into its analysis the OSFI model for MCCSR or its provincial or international equivalents where warranted. DBRS recognizes that OSFI, as the Canadian regulator, is the final arbiter of a life insurance company’s solvency and therefore regards the results of the model’s application as an important factor in its credit assessment.
- For Canadian life insurance companies, we expect an MCCSR ratio of at least 175% (or a higher amount defined as the company specific minimum established with its regulator) and a Tier 1 ratio of at least 120% across the investment-grade categories. Potential changes to the calculation of the capital ratio could result in these DBRS benchmarks changing.
- The risk-based capital ratio is calculated for regulatory purposes in the United States. U.S. operations are expected to maintain adequate local capital to maintain business confidence as well as regulatory compliance. Likewise, international affiliates are also expected to adequately meet local regulatory capital requirements and evidence of meeting these requirements can be part of the review.

**Return on Equity**

- The resulting financial performance of the consolidated company is best expressed as the core shareholders’ return on equity (ROE), where core earnings may be adjusted for non-recurring items. ROE is an effective measure of both profitability and efficient capital utilization.

**EBIT Fixed-Charge Coverage**

- The earnings before interest and taxes fixed-charge coverage ratio includes the interest on debt and the tax-adjusted dividend amounts paid to preferred shares. This ratio is performed at the consolidated level to capture the debt and preferred shares that may be issued by the holding company.

**Financial Leverage**

- The use of financial leverage is common for life insurance companies, both at the operating company level and at the holding company level in the form of senior debt, hybrid capital securities and preferred shares. The consolidated financial leverage ratio is defined as debt plus hybrids plus preferred shares over total capitalization.
- From time to time, capital market instruments representing operating leverage may be issued and may be excluded from the capital structure.
- The ability of the company to service its debt, hybrid and preferred share obligations is estimated over the economic cycle, assuming a long-term mature capital structure in line with DBRS expectations, given the company’s growth prospects and capitalization targets and strategies. Earnings available to meet debt service obligations are generally averaged to diffuse the impact of investment gains and losses and one-time adjustments to reserves without reducing the importance of low earnings volatility in assigning a credit rating.
- DBRS also assesses a company’s leverage through the assets-to-common equity leverage ratio. A more conservative company will typically have a lower ratio, representing a higher amount of equity capital underlying each dollar of liabilities.

**Holding Company**

- At the holding company level, DBRS looks at the following: the unconsolidated capital structure, which better captures the degree of structural subordination as reflected in the corporate organizational structure; the holding company’s access to liquid financial resources, without having to rely on upstream payments from regulated subsidiaries; and the degree to which double leverage is employed (i.e., incurrence of debt at the holding company to provide equity capital to operating subsidiaries), which is generally considered aggressive capitalization.
• While the most senior debt of a holding company is generally rated a single notch below the senior debt of the operating subsidiary, reflecting structural subordination alone, the debt of a more highly leveraged holding company — with limited earnings diversification, fewer sources of liquid funds such as dividends from unregulated or uncorrelated subsidiaries and a more aggressive strategy — is likely to be rated more than a single notch below its major operating subsidiary. Please refer to the criteria Rating Holding Companies and Their Subsidiaries.

• The capital structure of a mutual company, with limited access to capital markets, is not likely to be as aggressive as that of a company with readily available sources of financial support and liquidity.

**Asset Quality**

• Each insurance company can potentially have a different tolerance for asset quality depending on its investment management capabilities and risk management processes and procedures. A prima facie indicator of general risk tolerance on the asset side of the balance sheet is the relative amount of credit risk assumed in the form of BBB- and lower-rated bonds. Other asset quality measures might include the amount of non-fixed income assets in the portfolio.

• Under extreme market conditions or in the case of deterioration in the confidence of a life insurance company, it is particularly important a life insurance company has adequate liquid resources in order to meet its demand liabilities.

**ADDITIONAL FRR METRICS**

• While the primary FRR metrics above will be the most important metrics that DBRS will use in determining the FRR of an issuer, other metrics may be used, depending upon an issuer’s activities, capital structure, pension liabilities and off-balance sheet obligations.

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**Blending the BRR and FRR into a Financial Strength Rating**

• The financial strength rating is a blend of the BRR and FRR. In most cases, the BRR will have greater weight than the FRR in determining the financial strength rating.

• At the low end of the rating scale, however, particularly in the BB range and below, the FRR and liquidity factors play a much larger role, and the BRR would therefore receive a lower weighting than it would at higher rating levels.

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**Rating the Specific Instrument and Other Criteria**

• The issuer rating (which is an indicator of the probability of default of an issuer’s debt) is the basis for rating specific instruments of an issuer, where applicable. DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to the general rating information contained in the DBRS rating policy *Underlying Principles*.

• Preferred share and hybrid considerations are discussed under DBRS Criteria: Rating Preferred Share and Hybrid Criteria for Corporate Issuers.

• For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy *Short-Term and Long-Term Rating Relationships* and *DBRS Criteria: Commercial Paper Liquidity Support for Non-Bank Issuers*. 
• The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria Rating Holding Companies and Their Subsidiaries.
• Guarantees and other types of support are discussed in DBRS Criteria: Guarantees and Other Forms of Explicit Support.
• For further information on how DBRS evaluates corporate governance, please refer to DBRS Criteria: Evaluating Corporate Governance.