NO. 2/ OCTOBER 2013

The Litmus Rating Review
Reinsurance & Specialty

CONTENTS

Introduction

Welcome to the second edition of the Litmus Rating Review (the 'LRR'), Reinsurance & Specialty.

Since we launched last month we have had several discussions around the potential for the Litmus Composite Score (LCS) outcomes and the Resilience Indicators (RIs) to be used in ratings trigger wordings. The idea being that - both by providing an average rating outcome but also including the impact of rating 'outlooks' in the calculation - some of the perceived issues associated with trigger clause usage and wordings could be helped.

We are delighted to discuss that with anybody who wishes to do so (contact us at - info@litmusanalysis.com to arrange a meeting or a call).

Although, as ever, we stress we are not providing the underlying ratings ourselves, merely calculating an average from them.

Our recent commentary around the implications of a potential upgrade of the Lloyd's market rating to 'AA-' also seemed to get some attention (look at litmusanalaysisblog to see the article).

While not likely until 2014 (or even 2015) the unique aspect of this if it happens is that groups with little, if any, realistic prospect of having a 'AA range' company carrier could nonetheless offer 'AA-' paper via a Lloyd's platform.

The most notable recent rating action among the groups included in our LRR coverage was the upgrade of the Financial Strength Rating (FSR) of the core carriers of Axis by A.M. Best to an 'A+' (which translates to a 'AA-' on the S&P/Fitch rating scale). While not quite reaching the 'AA – (LCS)' level overall (due to S&P's 'A+' with a 'stable outlook') Axis' LCS is now the joint second highest among the L-Zebedee cohort (specialist international groups with significant operations in one or more of London, Zurich, Bermuda, Dublin or Singapore; see page 7).

We have also added Canopius to the L-Zebedee cohort list this month.

As ever we welcome your feedback.

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The Litmus Commentary: Our perspective on recent activity in the sector by the agencies

Date of comments: October 04 2013

Other than for those carriers highly impacted by sovereign ratings, ratings activity is still benign.

The agencies remain concerned about the impact of 'third party capital' but not yet to the extent that the degree of competition/pricing pressure is seen as having a materially negative impact on the credit profiles of traditional carriers.

The bottom line impact of low investment returns continues to be highlighted as a negative by some of the agencies (wrongly in our view other than to the extent that this leads to over-capacity in the industry) and a generally more competitive environment (including in previously positive areas like U.S. E&S) is highlighted as a generic concern but again is not yet leading to rating actions or even negative outlooks in most cases.

The robust capital position of the industry, its demonstrated resilience to significant 'cat.' events (and wider macro-economic problems) and the related strengths in the industry's ERM work are all supporting ratings and - in some cases – driving upgrades or at least positive outlooks.

AM Best

We touched on the main themes of Best's annual reinsurance report in edition 1 last month and they are largely in-line with the other agency views noted here (including their retention of a 'stable' outlook for the sector).

More noteworthy is the upgrade noted in the introduction of Axis' main carriers to an 'A+' on the Best FSR scale (i.e. AA- on the S&P/Fitch scale). This means Best now has four of our group reference carriers from the L-Zebedee cohort at the 'AA- level vs. just one (Renaissance Re) for S&P. Moreover none of the other three A.M. Best 'AA-' carriers have a positive outlook from S&P (all are 'A+ , stable').

While each case has its own specific features this illustrates a wider general observation we would make between Best and S&P ratings in the sector (and one that has become easier to define post the launch of S&P's new rating criteria and disclosure).

Essentially, other than in exceptional circumstances, under the S&P criteria even the highest level possible of risk adjusted, prospective capital adequacy still does not lead to a reinsurer's rating being higher than 'A+' unless the group is also perceived as having a 'very strong' competitive position; something S&P stresses should be not common (as indeed logic suggests it would not be; see our comments under 'S&P' below).

Best, by contrast, tends to allow for the premise that extremely strong capital adequacy in and of itself can lead to its equivalent of 'AA-' level ratings (albeit the hurdles around competitive position are also high).

This explains why both Best and S&P (along with Fitch) are at the 'A+, positive outlook' level for Lloyd's. Since the combination of both capital adequacy and competitive position ticks the boxes of each agency sufficiently for a 'AA-' outcome to be contemplated.

Fitch

Fitch has affirmed its stable outlook for the reinsurance sector. It remains wedded to the idea that low investment returns are a problem for the industry (in the sense of reduced investment income rather than their impact on over-capacity) and indeed it stresses that it expects 'the investment environment to provide the greatest challenge to the reinsurance sector in 2014'.
By contrast to S&P, Fitch does not see interest rate risk as a likely concern as and when rates do rise; calculating that each 100bp increase would result in an approximately 5% decline in the sectors global shareholders' equity.

Fitch also regards the inflation outlook as relatively benign for reinsurers over a 24 month time frame (in part because of action taken by reinsurers to mitigate liability inflation with inflation linked assets and other hedges).

Moody's

Moody's has affirmed its stable outlook for the global reinsurance industry (which basically means it sees the credit fundamentals of the industry, in the aggregate, as ratings neutral over a 12 to 18 month horizon).

Their reinsurance sector analysis (which tends to be fairly US-centric) sees the pricing trends in casualty as more positive than property (although in part due to disappointing current results in casualty as well as greater competition in property lines).

The Litmus Commentary: Our perspective on recent activity in the sector by the agencies

They also stress a 'high class problem' in property (that ever-better risk selection modelling and its wider use increases competition for the higher quality risks). Though we might have assumed the corollary would be less competition (and hence better pricing) for lower quality risks?

They also note that the return to positive valuations for the industry (equity price to book value in excess of 100%) has a knock on positive impact for credit risk in that it enhances financial flexibility.

Moody's has downgraded the core carriers of one of the L-Zebedee cohort (Endurance) from 'A2' ('A' on the S&P/Fitch scale) to 'A3, Stable' ('A-'), citing increased leverage (reduced capital adequacy) and operating performance (along with relatively limited diversification) as the rationale. By contrast S&P and Best remain at the 'A, Stable' level. Moody's notes however that the plans of new CEO John Charman will be 'credit positive' if successfully implemented. Endurance, it is fair to say, did not agree with the rating action!

S&P

Unlike the other three agencies S&P does not publish an industry outlook. Rather the factors generally considered for this are reflected in the 'industry risk' component of the IICRA scores used in the S&P rating process.

For global non-life reinsurance the 'industry risk' is scored as 'moderate' (despite the terminology that's the fourth riskiest out of six options), though for a geographically diversified reinsurer this is offset by a 'low' country risk score; giving an overall IICRA of 'intermediate' (the third riskiest out of six).

In contrast to some of the other agencies S&P notes that low interest rates are a positive for earnings as a source of pricing discipline rather than simply a hit to the bottom line (we concur). They therefore stress that the benefit of a rise in interest rates would be reductions in capacity-driven (especially alternative capacity) competition rather than enhanced investment returns.

Indeed they also note that the growth in asset bases of the industry has materially increased interest rate risk (fixed income portfolio write-downs due to rising rates).

An anomaly (from our point of view) in both S&P's view of the sector and its individual ratings is the number of 'strong' or better scores it assigns for 'competitive position' across what it defines as the 'top 23 global reinsurers'. This derives from its 'sum of the parts' analysis of the 6 sub-factors that make up this overall rating factor. In particular two of the 6 sub-factors (Geographic Diversification and Other Diversification) tend to be scored 'positive' for a global reinsurer leading to an inherent likelihood that positive sub-factors outweigh the negatives (the pre-condition for a score of at least 'strong').

But, taking a top-down view , quite how 22 of the 23 leading players in a global industry - within which they are basically all offering the same product via highly concentrated distribution channels and where their clients have little if any 'switching costs' - can have at least 'strong' competitive positions seems to us something of a mystery.

We believe the answer is in part that this is a generic view held by S&P vs. other sectors of the global insurance industry; they consider that reinsurance as an industry lends itself to its global players having strong competitive positions vs. other sectors (partly for the 'diversification' sub-factor reasons noted above). But does that really ring true as an overall premise? And, if so, how come third party capital can make the in-roads that it is?

In any event, it's an important view for them to hold as without it their reinsurer ratings would be noticeably lower.

Litmus Composite Score (LCS) Methodology

Purpose
We have developed an approach to deriving a score from the composite of ratings for three key reasons:

- One of the main agencies (A.M. Best) commonly used in the insurance sector has a different rating scale from the others, with fewer rating levels, making it difficult to compare ratings;
- We believe that 'Outlooks' are important indicators insufficiently used in insurance markets;
- A composite 'average' is subject to less volatility than a single indicator, and therefore a healthy development for the market.

Overview
The two most widely referred to rating agencies in the global reinsurance and specialty lines sector are A.M. Best and S&P. Most groups active internationally in the sector have a financial strength rating (FSR) from both agencies assigned to at least their main carriers. We highlight the rating assigned to what we consider to be a main group carrier (or where that is not clear, a significant carrier for the group in this sector). This is described by us as the 'group reference carrier'. Lloyd's syndicates are not considered for this as we use the Lloyd's market rating for LRR reporting.

We begin by producing the Litmus Score (LS). This translates each agency's Financial Strength Rating (FSR) on the group reference carrier to a numerical score. The exact score assigned reflects both the rating and the rating outlook. As A.M. Best uses a different rating scale from S&P for FSRs we use the A.M. Best Issuer Credit Rating (ICR) assigned to the group reference carrier (and its outlook).

Where ratings from both agencies exist we then produce the Litmus Composite Score (LCS) and map that back to the S&P rating scale.

Where there is no clear outcome for the LCS mapping we use Fitch and/or Moody's ratings as 'tie-breakers'. If this still produces no clear outcome we then give greatest weight to the rating from whichever of S&P and A.M. Best has the lowest mean Litmus Score for the cohort from those carriers rated by both agencies.

The Litmus Score (LS)
The LS is calculated out of 100. Each notch on the S&P rating scale is covered by 4 points on the LS scale. For example, a 'AA-' rating with a 'stable' outlook is assigned an LS of 88, whereas an 'A+' rating with a 'stable' outlook is assigned an LS of 84.

A positive or negative outlook respectively increases or decreases the LS relative to that for the stable outlook by one point.

The Litmus Composite Score (LCS)
The LCS is the arithmetic mean of the LS outcomes. Where the group reference carrier has only one rating from A. M. Best or S&P this is not assigned. We do not substitute either a Fitch or Moody's rating in such a case as this would challenge the consistency of the calculation process (however we are very open to market participant feedback on this).

In the event that the LCS comes out at a point equidistant from the relevant ratings scale mappings (e.g. as with an LCS outcome of 86 being two points from both the AA- and A+ mappings) we employ the 'tie-breaker' process described later.

The use of A.M. Best ICRs
In order to create a consistent basis of calculation we use the A.M. Best ICR issued on the group reference carrier as this is assigned using the same scale as S&P FSRs. It should be noted that we are making no judgment as to whether S&P and A.M. Best ratings are equivalent when expressed using the same scale.

A.M. Best assigns ICRs to rated carriers that issue policies at the same level as the FSR (but, as above, using the same scale that S&P uses for its FSRs). The outlook can however vary between Best's FSR and ICR on the same rated carrier. This is because of the greater number of gradations in the S&P type scale. For the LS and LCS calculations we use the ICR rating and outlook.

Rating Scale Mapping Tie-breakers

Where, as noted above, the LCS comes out at a point equidistant from the relevant ratings scale mappings, we use the Fitch and/or Moody's Insurer Financial Strength Ratings (IFSs) on the group reference carrier as the tie-breaker. Both ratings are used if both exist or just one if not.

Litmus Scores calculated from Fitch/Moody's IFSs are not included in the LCS (as this would challenge the consistency of the calculation) rather they simply impact the selected rating scale mapping of the LCS where a tie-break on this is required. Thus, if the Fitch/Moody's LS outcome is below that of the LCS the lower mapping is selected and if the Fitch/Moody's LS outcome is above that of the LCS the higher mapping is selected.

In the event that neither Fitch nor Moody's ratings on the group reference carrier exist, or that they also do not differentiate between the two mapping options, the S&P/A.M. Best rating from the agency with the lower mean LS for that cohort (on those group reference carriers rated by both) is given greater weight in deciding the mapping (this does not change the LCS).

Litmus Composite Score (LCS) Resilience Indicator (RI)

The LCS Resilience Indicator highlights how close the LCS outcome is to a rating scale mapping below its current level.

RI Code		LCS Mapping Description
R7	Highest	The current rating mapping reflects the application of a negative 'tie-break' and hence the LCS is the highest possible for that rating scale mapping
R6	High	The LCS is materially above the median score for that rating scale mapping
R5	Moderately High	The LCS is somewhat above the median score for that rating scale mapping
R4	Average	The LCS is exactly at the median score for that rating scale mapping
R3	Moderately Low	The LCS is somewhat below the median score for that rating scale mapping
R2	Low	The LCS is materially below the median score for that rating scale mapping
R1	Lowest	The current rating mapping reflects the application of a positive 'tie-break' and hence the LCS is the lowest possible for that rating scale mapping

Ratings Round-up, LS and LCS outcomes - Majors

Ratings as at 04/010/2013

We have used the following abbreviations -

[1]ISO 3166-1 Alpha-2 codes

[2]Pos=Postive, St=Stable, Neg=Negative

[3]F=Fitch, M=Moody's

				S&P Ratings		A.M. Best Ratings						
Cohort	Group Reference Carrier (LUCID Company Name)	GRC Domicile[1]	LUCID	S&P FSR/Outlook[2]	Litmus Score	AM Best FSR[2]	AM Best ICR/Outlook[2]	Litmus Score	Litmus Composite Score (LCS)	LCS Ratings Mapping	LCS Resilience Indicator	Tie-break Source[3]
Majors												
Ace	ACE Tempest Reinsurance Ltd	BM	ACEG/A1445A	AA-/Pos	89	A+	aa/Pos	93	91	AA (LCS)	R3	
Alleghany	Transatlantic Reinsurance Co	US	ALLE/A1213A	A+/St	84	A	a+/St	84	84	A+ (LCS)	R4	
Berkshire Hathaway	National Indemnity Co	US	BEHA/A2374A	AA+/Neg	95	A++	aaa/St	100	97.5	AA+ (LCS)	R6	
Everest Re	Everest Reinsurance Company	US	EVER/A1756A	A+/St	84	A+	aa-/St	88	86	AA-(LCS)	R1	F
Fairfax	Odyssey Reinsurance Company	US	FAIR/A1855A	A-/St	76	A	a+/St	84	80	A (LCS)	R4	
HDI	Hannover Rueckversicherung SE	DE	HDIG/A2565A	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4	
Mapfre	Mapfre Re, Compania de Reas SA	ES	MAPF/A2319A	BBB+/Neg	71	A	a/Neg	79	75	A- (LCS)	R3	
Munich Re	Munich Reinsurance Co	DE	MUNR/A2234A	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4	
Partner Re	Partner Reinsurance Co Ltd	BM	PART/A1957A	A+/St	84	A+	aa-/St	88	86	AA-(LCS)	R1	F
QBE	QBE Reinsurance Corp	US	QBEG/A2544A	A+/St	84	A	a+/Neg	83	83.5	A+ (LCS)	R3	
SCOR	SCOR Global P&C SE	FR	SCOR/A2437A	A+/St	84	A	a+/St	84	84	A+ (LCS)	R4	
Swiss Re	Swiss Reinsurance Company Ltd	CH	SWRE/A1798A	AA-/St	88	A+	aa-/St	88	88	AA- (LCS)	R4	
Tokio Marine	Tokio Millenium Re Ltd	BM	TOMA/A2016A	AA-/Neg	87	A++	aa+/St	96	91.5	AA (LCS)	R3	
White Mountains	Sirius International Insurance Corp	SW	WHMO/A2259A	A-/St	76	A	a/St	83	78	A (LCS)	R1	F
XL	XL Re Ltd	BM	XLGR/A2200A	A/Pos	81	A	a/St	**80**	80.5	A (LCS)	R5	

Please note that Litmus Analysis is not a rating agency

- The ratings and outlooks shown are from 4 October 2013. Ratings can and do change and we strongly advise readers to check with the relevant websites, A.M. Best (www.ambest.com) and/or S&P (www.standardandpoors.com), for the latest information and for the relevant rating definitions.
- Where a rating or outlook has changed since the date noted above Litmus will be pleased to consider recalculating the LS, LCS and RI privately for any LRR reader on request. This is a complimentary service and we are pleased to offer this wherever practical, however it is subject to our other commitments and availability.
- Litmus has not sought any endorsement from AM Best or S&P for the LS and LCS calculation methodology and results. Nor do we offer an endorsement of the AM Best or S&Ps ratings quoted here.
- LUCID is our online group and carrier identification system (see page 8).
- Please note that the Litmus Scores are not ratings; Litmus Analysis is not a rating agency.

Ratings Round-up, LS and LCS outcomes - "L-Zebedees"

Ratings as at 04/010/2013

We have used the following abbreviations -

[1]ISO 3166-1 Alpha-2 codes

[2]Pos=Postive, St=Stable, Neg=Negative

[3]F=Fitch, M=Moody's

				S&P Ratings		A.M. Best Ratings						
Cohort	Group Reference Carrier (LUCID Company Name)	GRC Domicile[1]	LUCID	S&P FSR/Outlook[2]	Litmus Score	AM Best FSR[2]	AM Best ICR/Outlook[2]	*Litmus Score*	*Litmus Composite Score (LCS)*	*LCS Ratings Mapping*	*LCS Resilience Indicator*	*Tie-break Source[3]*
L-Zebedees												
Arch	Arch Reinsurance Ltd	BM	ARCH/A1412A	A+/St	*84*	A+	aa-/St	*88*	*86*	*A+ (LCS)*	*R7*	*F,M*
Argo	Argonaut Insurance Co	US	ARGO/A1344A	A-/Neg	*75*	A	a/St	*80*	*77.5*	*A- (LCS)*	*R6*	
Allied World	Allied World Assurance Company Ltd	BM	AWAC/A2272A	A/St	*80*	A	a/Pos	*81*	*80.5*	*A (LCS)*	*R5*	
Amlin	Amlin AG	CH	AMLI/A1118A	A/St	*80*	A	a/St	*80*	*80*	*A (LCS)*	*R4*	
Aspen	Aspen Insurance UK Ltd	UK	ASPE/A1435A	A/St	*80*	A	a/St	*80*	*80*	*A (LCS)*	*R4*	
Axis	AXIS Specialty Ltd	BM	AXIS/A2433A	A+/St	*84*	A	aa-/St	*88*	*86*	*A+ (LCS)*	*R7*	*F,M*
Beazley	Beazley Insurance Company Inc	US	BEAZ/A4417A	N/R	*N/A*	A	a/St	*80*	*N/A*	*N/A*	*N/A*	
Catlin	Catlin Insurance Company Ltd	BM	CATL/A1692A	A/St	*80*	A	a/St	*80*	*80*	*A (LCS)*	*R4*	
Canopius	Canopius US Insurance Inc	US	BREG/A4442A	N/R	*N/A*	A-	a-/Neg	*75*	*N/A*	*N/A*	*N/A*	
Endurance	Endurance Specialty Insurance Ltd	BM	ENDU/A1958A	A/St	*80*	A	a/St	*80*	*80*	*A (LCS)*	*R4*	
Hiscox	Hiscox Insurance Company Ltd	UK	HISC/A2528A	A/St	*80*	A	a+/St	*84*	*82*	*A+ (LCS)*	*R1*	*F*
Lancashire	Lancashire Insurance Company Ltd	BM	LANC/A2448A	A-/St	*76*	A	a/Pos	*81*	*78.5*	*A (LCS)*	*R2*	
Lloyd's	N/A	NA	NA	A+/Pos	*85*	A	a+/Pos	*85*	*85*	*A+ (LCS)*	*R5*	
Markel[4]	Markel Bermuda Ltd	BM	MARK/A1261A	A/St	80	A	a/St	80	80	A (LCS)	R4	
Montpelier	Montpelier Reinsurance Ltd	BM	MONT/A2090A	A- /St	*76*	A	a/St	*80*	*78*	*A (LCS)*	*R1*	*F*
Platinum	Platinum Underwriters Bermuda Ltd	BM	PLAT/A2336A	A- /St	*76*	A	a/St	*80*	*78*	*A (LCS)*	*R1*	*F*
Renaissance	Renaissance Reinsurance Ltd	BM	RENR/A1894A	AA-/St	*88*	A+	aa-/St	*88*	*88*	*AA- (LCS)*	*R4*	
Validus	Validus Reinsurance Ltd	BM	VALI/A1992A	A/St	*80*	A	a/St	*80*	*80*	*A (LCS)*	*R4*	
W R Berkley	Berkley Insurance Co	US	WRBE/A1759A	A+/St	*84*	A+	aa-/St	*88*	*86*	*A+ (LCS)*	*R7*	*S&P*

[4]Markel Bermuda (formerly Alterra Bermuda) is used as the Markel group GRC as S&P doesn't currently rate the Markel group carriers that were not part of the acquisition. It should be noted that both S&P and A.M. Best's current ratings on the 'Alterra' carriers (including those now branded as 'Markel') don't reflect 'core' status to the group.

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About Litmus Analysis

Litmus is staffed by senior ex-rating agency personnel and provides a range of analytical services to the re/insurance markets and those that serve them.

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Understanding Non-life Re/insurer Financials and Key Ratios
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giorgiapaganuzzi@litmusanalysis.com

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For Ratings Advice, Market Security Assistance and Analytical Services, please contact Peter Hughes on peterhughes@litmusanalysis.com

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LitmusQ - The online credit-scoring tool for the insurance markets - your cedant and reinsurer financial health assistant.
For details, for a demo or a free trial, contact info@litmusanalysis.com

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