FAQ to Criteria for Rating Insurance Companies:

Applying regulatory insulation to Financial Strength Ratings

FAQ: Applying regulatory insulation to Financial Strength Ratings

GCR has added the FAQ below on the Criteria for Rating Insurance Companies to provide greater clarity regarding the approach to regulatory insulation for financial strength ratings.

In essence, the criteria allows GCR to provide greater levels of regulatory insulation for the Financial Strength Ratings ("FSR") of insurance companies. As a result, the below criteria can be used to guide the application of the insulation criteria found on page 23 of the Criteria for the GCR Ratings Framework. We will seek to apply the relevant sections under the GCR Ratings Framework, however should the operating environment of the parent be lower than that of the subsidiary, this FAQ may be used a guide.

The below FAQ does not apply to issuer or issue credit ratings for the same rated entities.

FAQ

What types of rated entities and ratings could be affected?

This FAQ exclusively refers only to the financial strength ratings of well-regulated life and non-life insurance companies. Typically, these companies will be wholly or majority owned subsidiaries, operating in relatively stronger country risk jurisdictions, which have stronger credit fundamentals than their cross-border parents.

What are the situations where this FAQ would apply?

GCR requires that the primary domestic prudential insurance regulator (of the rated entity) has the explicit capacity and willingness to insulate policyholders of an insurance company from cross-border parental contagion. Most pertinently, the regulatory framework should explicitly state that policyholders' obligations are preferred against all other creditors, including those of cross border parents. We must also be convinced that the regulator has the statutory power to stop dividends, remove management, change ownership, ring-fence policyholder liabilities and that the supervision and oversight is frequent and robust enough to prevent related party transaction(s) and dividend stripping.

We will also only consider cross border insulation, due to our belief that a regulator is more likely to protect policyholders if it causes no other systemic risks.

We may include insurance subsidiaries that are owned by non-insurance entities.

For the provisions of this FAQ to apply, there should be limited related party exposures. GCR will typically consider related party exposures above 10% as highly contagious to the subsidiary, resulting in the capping of the FSR rating at the risk score of the parent.

What are the guidelines for applying the GCR Framework guidelines on insulation?

In determining the FSR rating, the following steps will be taken:

a. We will not cap the FSR at the weaker cross border group rating.

b. GCR will stress capital to the level of regulatory intervention, which will typically be the minimum capital requirement as defined by the risk-based solvency regime, or an equivalent regulatory prudential target. This minimum capital level is typically considered to be equivalent to a capitalisation score of -2 or lower, depending on history of regulatory enforcement.

c. Furthermore, liquidity may be stressed to the point of exchange control intervention or at least 30%, with resultant net stressed assets considered for the calculation of relevant liquidity ratios.

d. We will include no benefit in the competitive position for wider group franchise or diversification strengths,

Importantly, the Issuer Credit Rating will typically remain capped at the weaker parent's risk score, subservient to the wider group insulation criteria.

What about subsidiaries with split shareholding?

In addition, consideration would be taken of the risk mitigation effect of split shareholding between parents in weak jurisdictions and shareholders from the subsidiary's country of operation and other strong jurisdictions. Should GCR view the local or stronger shareholder as having sufficient control to prevent the weaker parent's shareholder and management actions from impairing the financial condition of the insurer beyond strategic targets, the group cap of the weaker parent may not apply and the score may not exceed that of the stronger parent. In this case, the same capital and liquidity stresses as highlighted above may not be applied.

A worked example of FSR regulatory insulation

Company	Group position	Operating environment score	Risk score
A	Parent	5	5
B	Majority owned subsidiary	10	14

Company B scores

Scenario	1	2	3
Risk scores	Company B (stand-alone)	Company B (Capped at Parent level)	Company B (insulation stress)
Operating environment	**10.0**	**10.0**	**10.0**
Business profile	**0.5**	**0.5**	**-1.0**
Financial profile	**3.5**	**3.5**	**-1.0**
Earnings	1.0	1.0	1.0
Capitalisation	1.5	1.5	-2.0
Liquidity	1.0	1.0	0.0
Comparative profile	**0.0**	**-9.0**	**0.0**
Total Score	**14.0**	**5.0**	**8.0**

In the above table, scenario 1 represents the stand-alone risk score of Company B, presuming there is no risks emanating from a weaker parent.

Scenario 2 shows GCRs approach should there be a weaker parent and we do not consider regulatory insulation to be effective. In this scenario, although Company B has stand-alone total risk score of 14, the final risk score for Company B would be capped at the parent's '5' level, either because related party exposures to the weaker jurisdiction are more than 10% of capital, or if GCR considers there to be minimal regulatory insulation of the subsidiary. You can see the impact in the -9 adjustment of the comparative profile score.

Scenario 3 shows how GCR will stress stand-alone elements of Company B, should we consider insulation to be effective. In this scenario, we stress the financial strength of Company B to the point of regulatory intervention. Typically, GCR will reduce the capitalisation score to the lower of -2 and the stand-alone risk score, because the regulator is anticipated only to intervene close to or upon breach on local capital adequacy. Furthermore, we bring down the liquidity coverage ratio, to reflect exchange control limitations on externalisation of financial assets. This lowers the liquidity coverage ratio to 1.4x (from 2x, assuming a 30% maximum exchange control restriction), reducing the score from 1 to 0. The business profile is typically moderated to the lower of a score of –1 and the stand-alone risk score, to reflect limited support to the financial profile. However, unlike the second scenario we do not adjust for parent weaknesses in the comparative profile. As a result, the final risk score for Company B would be 8 (14-1.5-3.5-1).

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