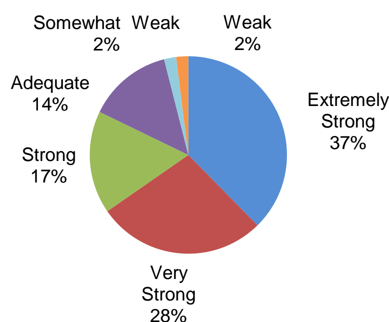
Prism Factor-Based Capital Model Results

EMEA Insurance Sector Strongly Capitalised – A Key Credit Positive

Special Report

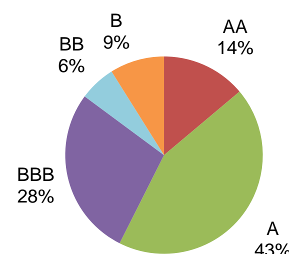
EMEA Insurers Strongly Capitalised: Following the launch of its Prism Factor-Based Model (Prism FBM) in September 2014, Fitch Ratings has carried out a capital analysis of its EMEA insurance portfolio, using end-2013 data. The portfolio is strongly capitalised, with 82% of entities scoring 'Extremely Strong', 'Very Strong' or 'Strong', typically above or in line with their ratings. Most ratings are constrained by factors other than capital, e.g. low profitability, high financial leverage, sovereign constraints, limited scale or lack of business diversification.

Figure 1
Prism Scores
EMEA, end-2013



Source: Fitch

Figure 2
IFS Ratings
EMEA, end-2013



IFS: Insurer Financial Strength
Source: Fitch

Equity Drives Available Capital: Net equity is the largest component of Fitch-calculated Total Available Capital (TAC). However, it accounts for only 47% of TAC across the portfolio, as there are several other important components. Capital buffers, e.g. funds for future appropriation, account for 14%, subordinated debt 15%, and value of in-force business 13%.

Asset Risk Is Key: For life insurers, Target Capital (TC) is dominated by asset risk, which accounts for 65% across the life portfolio. For non-life insurers and reinsurers, the largest components of TC are asset, catastrophe, motor, property and liability risk, reflecting the business mix in the portfolio. Asset risk is the largest component, accounting for 24% of TC, but it is significantly lower than for life insurers because non-life insurers and reinsurers generally focus on taking insurance risk and tend to minimise asset risk.

Diversification Benefit Is Significant: Prism FBM gives credit for diversification between product lines, asset types and business types. Diversification benefit across Fitch's EMEA portfolio ranges from 5% to 35% (as a percentage of TC), with composite insurers having the largest benefit, typically around 25%-30%. Even monoline insurers have some diversification benefit, reflecting the diversification between asset and insurance risks and between asset.

Prism Versus Other Metrics: To assess capital adequacy, Fitch considers Prism scores, regulatory solvency, leverage metrics and insurers' own capital models. The Prism score is the main focus because, unlike most other metrics, it is both risk-based and comparable across markets. It also factors in certain risks and sources of capital that may not be reflected in regulatory metrics. For example, it allows directly for asset risks that vary by rating and duration, and capital buffers such as funds for future appropriation are fully factored into TAC.

Role of Capital in Ratings: Capital strength is one of the key credit factors Fitch uses to establish ratings for insurers. Capital strength does not in itself establish the rating but Fitch would typically expect insurers to have a Prism FBM score at least in line with their rating level.

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EMEA Insurance Sector Strongly Capitalised

Prism Scores Show Widespread Capital Strength

Following the launch of its Prism FBM risk-based capital model in September 2014, Fitch has carried out a capital analysis of its EMEA insurance portfolio, based on end-2013 data. The results confirm the agency's view that, in aggregate, the rated EMEA insurance sector is strongly capitalised, with 82% of rated entities scoring 'Extremely Strong', 'Very Strong' or 'Strong'.

This capital strength is partly a reflection of the sample group. Rated insurers are a select group within the overall market, typically with stronger financial profiles than unrated insurers.

The capital strength also reflects macro-economic factors, particularly quantitative easing and low interest rates, which have generated large unrealised gains on insurers' invested assets. In addition, the global financial crisis led many insurers to bolster capital in recent years, e.g. through balance sheet de-risking and retention of earnings.

Some insurers score 'Extremely Strong' because they are focused on business that is not capital consuming, e.g. unit-linked savings products, or because their business model tends to be highly capitalised by nature, e.g. some mutuals and captive insurers.

Figure 3 shows a mapping of Prism scores to Insurer Financial Strength (IFS) rating category benchmarks. For example, if the Prism score is 'Strong', this implies that capital adequacy is of 'A' IFS quality. Fitch would typically expect insurers to have a Prism FBM score at least in line with their rating level. Any company failing to achieve the 'Somewhat Weak' category is considered to have 'Weak' capital.

Figure 3
Mapping of Prism Scores to IFS Rating Categories

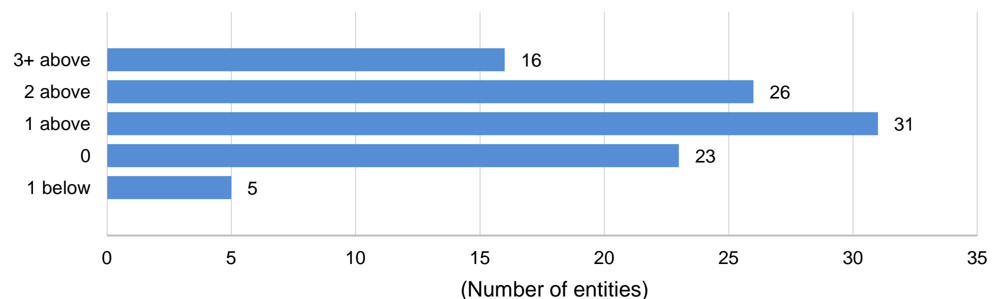
Prism score	IFS
Extremely Strong	AAA
Very Strong	AA
Strong	A
Adequate	BBB
Somewhat Weak	BB

Source: Fitch

Capital Levels Are Credit Positive

The aggregate capital position of the EMEA insurance industry is a credit positive. On the whole, insurers' capital positions are above or at least in line with the ratings assigned. Most ratings are constrained by factors other than capital, e.g. low profitability, high financial leverage, sovereign constraints, limited operating scale or lack of business diversification.

Figure 4
Prism Score vs. IFS Rating
EMEA, end-2013
(Category difference)



Source: Fitch

An issuer-by-issuer comparison of Prism scores against ratings shows significant numbers of issuers with scores in line with ratings, one category above, two categories above or even three or more categories above their rating level. There are only a few issuers whose capital position is below the level commensurate with the rating level. In these cases, the issuers' ratings are typically boosted by a dominant market position or the credit quality of the owner. However, the uplift from other factors is usually limited and no issuers are rated more than one category above their Prism score.

Related Criteria
Insurance Rating Methodology (September 2014)

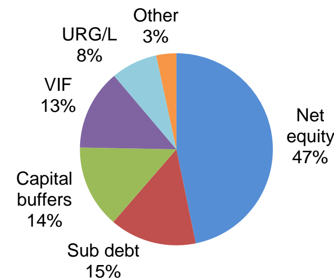
Prism Score Components

The Prism score is driven by the ratio of Total Available Capital (TAC) to Target Capital (TC) under various stress scenarios.

TAC represents the amount the insurer could monetise its free assets for in a stressed run-off scenario over the lifetime of the in-force policies.

TC represents the amount of capital that the insurer would be projected to need in excess of its current best-estimate liabilities, under various stressed run-off scenarios.

Figure 5
Total Available Capital
EMEA, end-2013



VIF: Value of in-force business
URG/L: Unrealised gains/losses
Source: Fitch

Total Available Capital

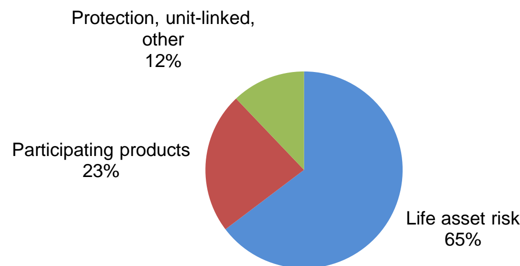
Across Fitch's EMEA insurance portfolio, net equity is the largest component of TAC, accounting for 47% of the total. Capital buffers, e.g. funds for future appropriation, account for 14%, meaning that net equity and capital buffers together – which form 'Fitch Core Capital' (FCC) – account for more than 60% of aggregate TAC.

FCC is 'very high quality' capital that Fitch considers to have a high level of certainty over the value attainable and to be relatively easily monetised. The rest of TAC is of lower quality and made up of items than can be calculated with less certainty or monetised less easily.

Within Fitch's portfolio, the non-life insurance sector has higher quality capital (FCC/TAC: 97%) than the life sector (FCC/TAC: 68%). This mainly reflects the credit for value of in-force business that life insurers get in the model.

Target Capital

Figure 6
Target Capital - EMEA Life
End-2013



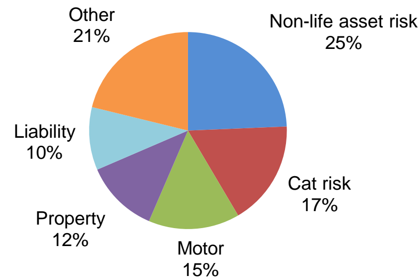
Source: Fitch

For life insurers, TC is largely driven by asset risk. This reflects the dominance of savings business on EMEA insurers' balance sheets, backed by large holdings of financial market investments, particularly government and corporate bonds, equities and property. This entails investment risks for insurers, notably credit risk and equity risk.

Figure 7

Target Capital - EMEA Non-Life

End-2013



Source: Fitch

For non-life insurers and reinsurers, the largest components of aggregate TC are asset, catastrophe, motor, property and liability risk, reflecting the business mix of the portfolio.

Although asset risk is important for non-life insurers and reinsurers, it accounts for a much lower proportion of TC than it does for life insurers. This is because life insurers typically have larger investment portfolios relative to their insurance risks, as their portfolios are dominated by long-term saving products with several years of accumulated premiums invested.

Non-life insurers and reinsurers tend to hold lower-risk assets that are more easily monetised, including significant cash and short-duration bonds, reflecting their focus on underwriting insurance risk. Most non-life insurers choose to take on only limited asset risk.

Diversification Benefit

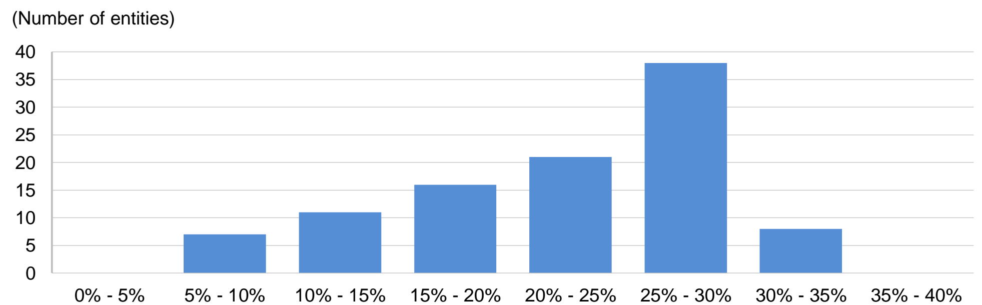
Prism FBM gives credit for diversification between product lines, asset types and business types. It does not give credit for diversification attributable to geography or size of portfolio; Fitch takes these into account qualitatively elsewhere in the rating process, outside the Prism score.

Figure 8

Diversification Benefit /Target Capital

EMEA insurers, end-2013

(Number of entities)



Source: Fitch

Diversification benefit across Fitch's EMEA portfolio ranges from 5% to 35% (as a percentage of TC under the stress scenario corresponding to an 'Adequate' score), with composite insurers having the largest benefit, typically around 25%-30%. Even monoline insurers have some diversification benefit, reflecting the diversification between asset and insurance risks and any asset diversification they have.

Prism FBM Versus Other Capital Metrics

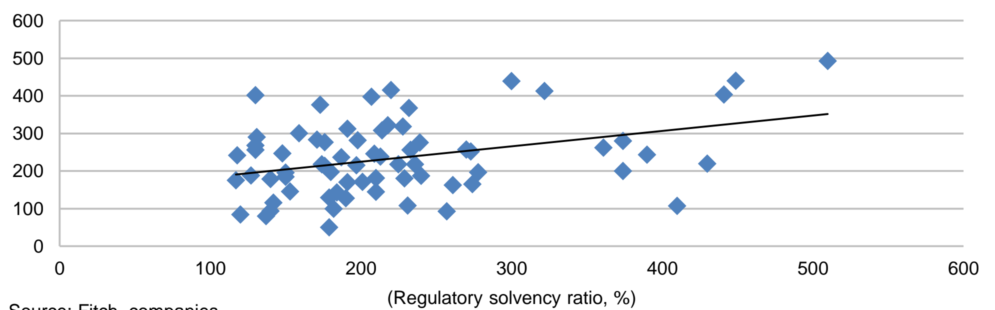
To assess capital adequacy, Fitch considers Prism scores, regulatory capital ratios, leverage metrics and, to a lesser extent, insurers' own in-house capital models.

Prism FBM is typically the primary focus as it gives a risk-based capital score that, unlike regulatory metrics, is comparable across markets, geographies and accounting standards. Figure 9 shows that the correlation between Prism scores and regulatory solvency ratios is weak. Regulatory solvency ratios are not a good predictor of Prism scores, as Prism scores reflect additional risks and sources of capital, which are often significant. For example, the Prism FBM charges for credit risk allow directly for credit rating and duration, and capital buffers such as funds for future appropriation are fully factored into the AC.

Figure 9

Prism Score vs. Regulatory Solvency Ratio

(Prism score at 'Adequate' stress, %)



Source: Fitch, companies

Prism FBM Results – 2013 vs. 2012

Prism scores at end-2013 were mostly unchanged from end-2012, with both AC and TC stable across sectors and geographies.

Appendix 1: Capital in the Rating Process

Capitalisation features as part of one of the twelve main credit factors that Fitch uses when analysing insurance companies.

Capitalisation is assessed in conjunction with financial leverage. In EMEA, it is common for the two assessments to offset each other, with fairly high leverage (credit negative) offset by fairly high capital (credit positive). This is partly a consequence of the high use of hybrid debt in insurers' capital structures, reflecting the favourable regulatory treatment of hybrid debt in much of EMEA.

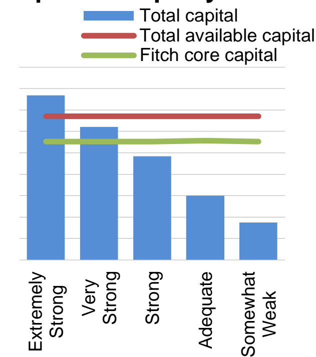
Figure 10

Key Credit Factors for Insurance Companies

Qualitative	Quantitative
Sovereign and country-related constraints	**Capitalisation** and leverage
Industry profile and operating leverage	Debt service capabilities and financial flexibility
Market position and size/scale	Financial performance and earnings
Ownership	Investment and asset risk
Corporate governance and management	Asset/liability and liquidity management
	Reserve adequacy
	Reinsurance, risk mitigation, and catastrophe risk

Source: Fitch

Figure 11
Capital Adequacy



Source: Fitch

Appendix 2: Obtaining a Capital Result with Prism FBM

Prism FBM calculates two key metrics: Available Capital (AC) and Target Capital (TC).

On AC, the model aims to quantify surplus assets available over and above those that cover the best-estimate liabilities that could be monetised to meet obligations with a reasonable degree of certainty over several years in an orderly run-off.

AC is defined at both the 'Fitch Core' and the 'Total' level, with Fitch Core Capital (FCC) being 'very high quality' while Total AC (TAC) is 'medium quality'. 'Very high quality' is defined as capital that is considered to have a high level of certainty over the value attainable and to be more easily monetised. 'Medium quality' capital is that which is monetised with a less certain value, or over a longer period to attain a higher value. Fitch applies haircuts to the reported value of capital to allow for this.

On the TC side, the model simulates shocks to the assets and liabilities of varying severity (severity increases from 'Somewhat Weak' to 'Extremely Strong') to establish the capital that is likely to be required to keep the company solvent with varying degrees of certainty for the lifetime of the policies on the books.

The benefit of diversification is allowed for between product lines and assets, but explicit credit is not given for geographical diversification or large company size. Instead, Fitch gives qualitative credit for these elsewhere in the rating process, outside the model.

AC and TC are then compared and represented in a graphical format (Figure 11). The Prism score is the most severe stress level at which AC exceeds TC ('Very Strong' in Figure 11).

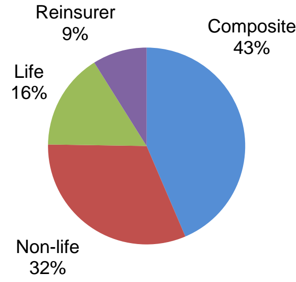
Fitch's assessment of capital strength does not in itself establish the rating. However, Fitch would typically expect a 'AAA'-rated insurer to have a Prism score of 'Extremely Strong', a 'AA'-rated insurer to have a Prism score of at least 'Very Strong', an 'A'-rated insurer to have a Prism score of at least 'Strong', a 'BBB'-rated insurer to have a Prism score of at least 'Adequate', and a 'BB'-rated insurer to have a Prism FBM score of at least 'Somewhat Weak'.

Appendix 3: Rated Portfolio Used for Results

Figure 12

EMEA Insurance Portfolio

By type of insurer, end-2013

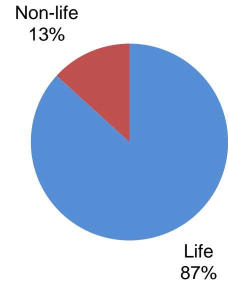


Source: Fitch

Figure 13

Asset Exposure

By type of insurance, end-2013



Excluding unit-linked
Source: Fitch

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