Rating Insurances

Overview of the methodological rating process
for insurances

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Introduction

From an economic perspective, the Swiss financial sector comprises all services provided by banks, insurance companies, and other financial service providers such as fund managers, stock exchanges or credit card companies in Switzerland. Overall, the companies in the Swiss financial sector generated a nominal gross value added (GVA) of CHF 69.2 billion in 2019, which corresponds to around one-tenth of Switzerland's total economic output. This makes the financial sector one of the highest value-added industry aggregates in Switzerland. The share of the insurance industry in the overall value added of the financial sector was 41.0% (banks: 43.7%, other financial service providers: 15.6%). This 41.0% of the insurance industry was divided among the various insurance branches as follows:

- **Non-life insurance 15.5%**
- **Reinsurance 9.2%**
- **Social insurance 8.6%**
- **Life insurance 5.6%**

Since 1998, the real GVA of the Swiss financial sector has grown somewhat faster than the real GVA of the Swiss economy as a whole. While the development of the insurance sector has been comparatively stable, the value added of banks and other financial service providers has been subject to much greater fluctuations, as they were more affected by the financial market crisis in 2008 and the bursting of the dotcom bubble in 2000, among other things. With the exception of 2002, real GVA in the insurance sector has grown in every year since 1998.

With a nominal GVA of CHF 26.1 billion and CHF 29.8 billion, the insurance industry and the banking industry were among the ten largest industries in Switzerland in 2020. These two industries thus accounted for more than four-fifths of the financial sector's value added in 2020. Only in wholesale trade (nominal GVA in 2020 of CHF 70.5 billion) and public administration (CHF 73.4 billion) was the nominal GVA in 2020 higher than in the financial sector (CHF 66.5 billion). At CHF 273 per hour worked, hourly productivity in the insurance sector in 2020 was around three times higher than in the Swiss economy as a whole (banks: CHF 143 per hour worked, other financial service providers: CHF 81 per hour worked). Employees in the financial sector in Switzerland totaled around 224,400 full-time equivalents (FTE) in the 2020 financial year. This corresponds to a share of around 5.3% of the overall economy. While bank employees accounted for 148,100 FTE in 2020, or around 3.5% of the total workforce in Switzerland, employees at insurance companies accounted for 76,400 FTE, or around 1.8% of the total economy.

The financial sector infrastructure, from which both the economy and the population benefit greatly, is also of great economic importance. Federal, cantonal, and municipal taxes directly or indirectly related to the financial sector amounted to around CHF 17.1 billion in 2020. This equates to a total of around 12% of the total fiscal revenues of the public sector.

Private insurers domiciled in Switzerland generated a total of nearly CHF 230 billion in premiums in 2020. Around three quarters of these premiums were generated abroad. In terms of premium volume in 2020, Zurich Insurance Group is the largest primary insurer in Switzerland with premiums of CHF 55.4 billion and Swiss Re the largest reinsurer with premiums of CHF 37.8 billion. The largest part of assets listed by private insurance companies in their balance sheets are investments. Insurance companies typically make this money available to the economic cycle as long-term investors.

Institutional Framework & Market

Federal supervision of insurance companies is governed by the Insurance Supervision Act and the associated Supervision Ordinance. The primary purpose of the corresponding law is to protect insured persons from insolvency risks of insurance companies and from abuses. Swiss insurance companies that offer direct insurance or reinsurance are subject to the law. These companies require a license from the Swiss Financial Market Supervisory Authority (FINMA) in order to carry out their insurance activities. FINMA groups insurance companies to be supervised into five risk categories. This allocation is made primarily on the basis of total assets. As of the end of 2021, there were 193 insurance companies and health insurance funds as well as six insurance groups subject to supervision by FINMA.

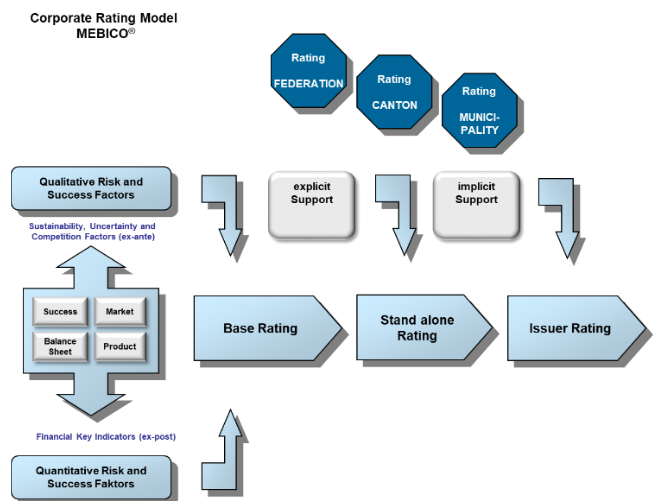
According to the law, insurance companies are obliged to ensure that the claims arising from insurance contracts are secured by tied assets. The corresponding target amount is 101%. This amount has to be covered at all times by the corresponding investments, for which strict guidelines apply. A key indicator in the supervision of insurance companies is the so-called SST ratio (Swiss Solvency Test). The aim of this supervisory tool is to ensure that insurance companies can provide the promised benefits on a sustained basis, taking into account all relevant market, credit, and insurance risks. It specifies the minimum amount of equity that an insurance company is required to have. The minimum amount is set depending on risks assumed by the insurance company. Accordingly, an SST ratio of 100% means that the available capital (risk-bearing capital) corresponds to the demanded capital (target capital).

Rating Concept

The rating model is designed as an expert system and, by its modular structure, takes account of the fact that the creditworthiness of insurances is determined both externally (exogenous) and internally (endogenous). In a first step, the exogenous creditworthiness factors are systematically analyzed, identified, and evaluated. In a second step, the endogenous creditworthiness factors are assessed on the basis of quantitative and qualitative factors.

Rating Architecture

The credit rating architecture basically consists of four modules and allows a consistent and flexible consideration of systematic credit-relevant factors for different insurance segments (see Figure 1).



1 Credit rating of insurances

Rating Methodology

The methodological foundation for valuation is a Logit function, which has been asymmetrically extended by several company-specific parameters. With regard to the traditional definition of the default risk, fedafin explicitly distinguishes

between the stand-alone rating (without implicit support) and the corporate rating (with implicit support) and displays them transparently on the corresponding credit rating documentation. Normally, stand-alone rating and corporate rating are identical for private insurance companies, as there is no support or guarantees.

Rating Criteria

When assessing creditworthiness, both qualitative and quantitative elements are considered when assigning a corporate rating to an insurance. In the quantitative part, the credit risk is identified, analyzed, and assessed on the basis of insurance-specific ratios from balance sheets and income statements from previous years (ex-post situation). This provides an objective picture of an institution's autonomous financial behavior in comparison with other insurances. In the qualitative part, the credit assessment is supplemented by various risk and success factors which have a systematic influence on the future development of the credit risk (ex-ante trend).

Qualitative Rating Criteria

Qualitative risk and success factors are systematically identified and evaluated by the rating committee. As part of the rating process, credit-relevant issues in four areas of the qualitative rating criteria for insurances are relevant (non-exhaustive):

Financial-Legal Interdependence & Support

- Financial guarantees of the owners
- Possible bailout by higher levels of government in a stress scenario

Institutional Framework & Market Environment

- Regulatory requirements (e.g. solvency ratios) and regulatory supervision
- Political and regulatory risks (e.g. intervention in tariff design with capping of premiums)
- Price development in the real estate market
- Total debt situation of private households

Corporate Structure and Transparency

- Legal form and complexity
- Corporate governance
- Internal controls and enterprise risk management
- Accounting and disclosure standards
- Balance sheet structure

Competitive Position & Corporate Strategy

- Corporate strategy design
- Earnings stability and its diversification
- Geographical diversification in insurance business
- International orientation
- Strategic risk profile of the company

Quantitative Rating Criteria

The systematic identification and evaluation of the financial circumstances takes place in form of a balance sheet rating. As part of the rating process, four credit-relevant factors within the financial autonomy and sphere of influence of an insurance are relevant (non-exhaustive):

Assessment of Capital Structure and Indebtedness

- Solvency ratio
- Equity ratio
- Leverage ratio
- Debt financing structure and its potential
- Payout ratio
- Equity / sales

Assessment of Liquidity

- Cash and cash equivalents
- Cash and cash equivalents / liabilities

Assessment of Earning Power and Profitability

- Combined ratio non-life
- Technical provisions non-life / net premiums non-life
- Net investment income
- Technical result non-life and life
- Investment result non-life and life
- Net income / sales

Assessment of Risk Profile

- Duration mismatch
- Provisioning policy
- Financial assets
- Hedging
- Market position
- Enterprise risk management

Outlook

The Swiss insurance sector faces a variety of challenges. Overall, the insurance market is saturated with good market penetration. Growth is therefore also limited in view of the cautious economic outlook and the less favorable asset situation of private households in some cases. Managing inflation risks also involves a variety of challenges. New products, even outside the core business, certainly offer opportunities, although the risks and returns must be weighed up carefully.

Technological progress is influencing the sector in many ways. Distribution structures with growing digital sales improve the cost structure, but also put pressure on traditional sales channels. By using digital analytics to reduce costs and optimize operations, efficiencies can be achieved, some of which can lead to market share gains in the form of more competitive pricing. Securing top-notch digital talent is not always easy.

Managing risk is, and will remain, key. Insurers today must deal with an unprecedented amount of risk. With the rapid pace of technological advancement, the scope of risks from which insurers must protect both themselves and others will continue to grow. Examples include cloud computing, cybersecurity, and climate change. To keep pace, insurers need to understand how to apply new solutions.

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