EthiFinance Ratings

Insurance Rating Methodology

1. Introduction

The ratings that EthiFinance Ratings performs are opinions on the credit profile of an issuer. These opinions are based on the analysis of historical data and assessments of the insurance company's future trends.

The opinions issued are stable over time due to the methodological approach of EthiFinance Ratings, without detriment to the possible revisions that may be carried out when there is a substantial change affecting the insurance company.

The credit profile refers to the insurance company's ability to make timely payments of its obligations to policyholders and contractual clients (Insurer Financial Strength Rating). The definition of default can be seen below:

- **Default:** non-payment by the insurance company of its commitments to third parties or the initiation of bankruptcy proceedings.

Insurance companies are non-credit financial entities since they do not provide credit to the system. However, they fulfil some economic-financial functions, such as the coverage of productive investments against unfavourable events through a stable investment policy in the financial markets.

The main feature of an insurance company is that first the flow of earnings or charges occurs and secondly the flow of technical expenses. This aspect from the point of view of the maturity period (the period that elapses from the time a company invests a monetary unit in the productive cycle of the entity, until it recovers it by selling a product or collecting a premium) is fundamental for the analysis of an insurance company.

2. Scope

The objective of this methodology is to represent EthiFinance Ratings' approach to rating insurance and reinsurance (hereinafter, the term insurance includes reinsurers) companies that operate both nationally and internationally and whose main activity is to cover, distribute or assume certain risks. This includes ratings in the life and non-life insurance sectors such as property & casualty or trade credit insurance.

The approach used by EthiFinance Ratings considers qualitative and quantitative elements. The use of past information and financial projections will form the basis of the analysis. However, this analysis includes subjective factors and nuances that reflect our opinion as accurately as possible. Likewise, the methodology described here must be understood in a flexible manner due to the dynamic nature of the sector to which it is addressed. Therefore, the importance of the factors described below could vary to adapt the analysis to these changes. Moreover, other factors, instead of those described below, can be used in case of being necessary.

3. Overview

The methodology is based on the determination of the insurance company's financial strength. The result of this assessment is the Insurer Financial Strength Rating, which includes the effect of systemic support and internal support of any related company and provides an opinion on the ability of the insurance company to make timely payments on its obligations to third parties.

In addition, the issued rating (solicited or unsolicited) is accompanied by an outlook (over the next year) that can be positive, stable, negative or under observation depending on the perspective of both the sector and the performance of the company.

EthiFinance Ratings covers individual insurance companies and insurance groups (life, non-life and reinsurance organizations). This methodology is applicable independently of their shareholding nature and the jurisdictional framework if their main activity is the coverage of productive investments against unfavourable events. Therefore, mortgage insurers, title insurers, bond insurers, insurance brokers and other intermediaries are excluded from the scope of the rating.

The low interest rate scenario, prolonged over time and probably extended after the covid crisis is having a negative impact on the expansion of the life business. However, its potential development is very important in the future context of the inability of public pension systems to provide a sufficient response to the deficit of pension savings that the demographic context, with low birth rates and increasing longevity, imposes on advanced economies. The dynamism of the insurance market in emerging economies has its fundamental explanation in this condition, which in recent years has been led by China. Additionally, the emergence of new risks associated with innovation, technological intensification, digitalization, and environmental and climate changes that are currently being experienced could be the source of a disruptive expansion of insurance activity.

4. Insurance Companies Assessment

EthiFinance Ratings utilizes three analytical categories to analyse the credit risk of an insurance company. These categories are made up of a series of factors that aim to reflect, as faithfully as possible, the main aspects that determine the strength of the company.

The analytical categories, which will be developed in depth later, are the following:

- **Operating environment**: sovereign rating and regulation.
- **Company profile**: business model, positioning, and management & risk profile.
- **Financial profile:** earnings & profitability, capitalization & leverage, liquidity.

Table I: Analytical framework I

		Categories	Criteria	Factors
INSURER RATING	Stand Alone Assessment	Operating environment (15%)	Sovereign risk (5%)	Sovereign rating (5%)
			Regulation (5%)	Prudential regulation (5%)
			Sector dynamics (5%)	Sector strength (5%)
		Company profile (45%)	Business model (15%)	Diversification (8%)
				Distribution channels (7%)
			Positioning (10%)	Market share (5%)
				Peer analysis (5%)
			Management and risk profile (20%)	Risk profile (7%)
				Governance (7%)
				Brand (6%)
		Financial profile (40%)	Earnings & Profitability (15%)	Core metrics
			Liquidity (10%)	
			Capitalization & Leverage	
		Adjustments	Support	Notching

*Source: EthiFinance Ratings

EthiFinance Ratings defines the insurance company's stand-alone assessment as the likelihood that it fails to make timely payments of its obligations to policyholders and contractual clients in the absence of any support. It is the opinion about its solvency profile, taking into account the combination of all three of the aforementioned categories. It does not consider the possible systemic support or shareholders/related entities' support.

Despite assigning a quantitative weight to each factor, the final assessment considers qualitative aspects beyond factor weightings due to the static nature of the ratios that could limit the explanatory capacity of the category. Hence, adjustments up to 2 notches can be made to the factors used to incorporate complementary information. Examples of this complementary information can include expected trends, some aspects not covered by the ratio or any kind of nuance improving the quality of the data.

Table II: Analytical framework II

KPIs	Starting score	Adjustment	Final score	Driver
Sovereign Rating	3		3	
Prudential Regulation	2		2	
Sector Strength	4		4	
Diversification	3		3	
Distribution Channels	4		4	
Market Share	5	+1	6	Highly volatile customer base
Peer Analysis	4		4	
Risk Profile	4		4	
Governance	6		6	
Brand	5		5	
RoA	4		4	
RoE	3		3	
Combined Ratio	4	+1	5	Expected negative trend
Fixed Charge Coverage Ratio	4		4	
Net Earned Premiums to Equity	6	+1	7	High ceded premium rate increasing reinsurance risk
Regulatory Capital Ratio	1		1	
Financial Leverage Ratio	3	-1	2	Very favorable term structure and conditions
Liquid Assets to Policyholder Liabilities	2		2	
Asset Liability Management	3		3	

*Source: EthiFinance Ratings

As can be seen in table II, the assessment of the analytical factors is made through a numeric scale which ranges from 1 to 10 (1 being the best). The combination of these factors makes up the assessment of each category and the combination of the three categories will result in the insurance company's stand-alone assessment. The final scoring will be mapped with the long-term rating scale of EthiFinance Ratings[1].

Score	1	2	3	4	5	6	7	8	9	10
Rating	AAA	AA	A	BBB	BB	B	CCC	CC	C	D

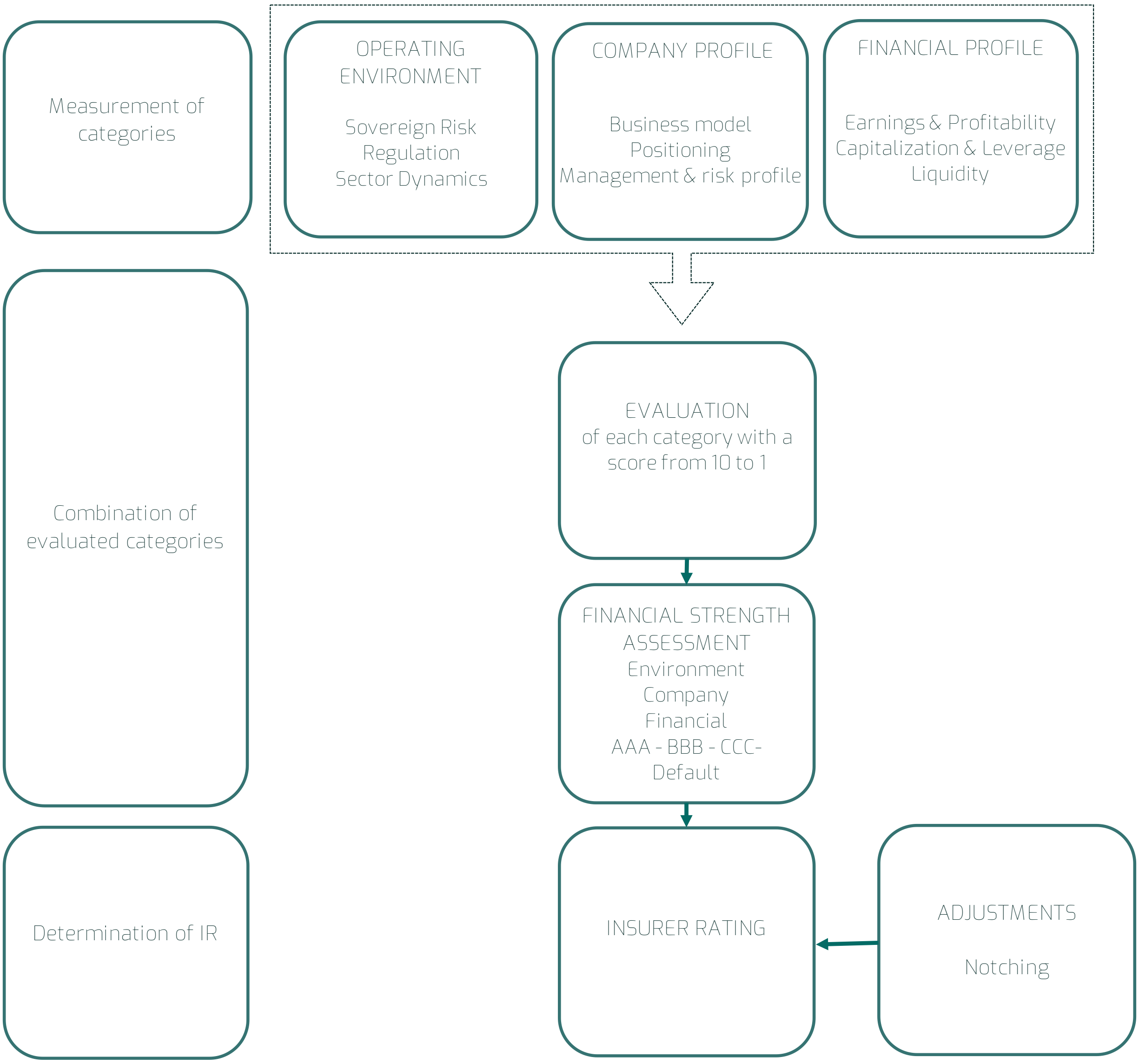
*Source: Ethifinance Ratings.

However, the categories are not isolated compartments, but are related to one another, affecting each other positively or negatively. In such circumstances EthiFinance Ratings may rebalance weightings to reflect the relatively lower importance of the category.

Once the insurance company's Financial Strength Assessment has been obtained, the rating will be modified by the possible external or internal support. After this adjustment, the result will be the Insurer Rating.

[1] This document updates the previous version while preserving its original methodological criteria; therefore, all existing ratings remain unchanged. In this version, the format has been updated and includes a higher level of detail.

Workflow Assessment



*Source: EthiFinance Ratings

Additionally, since January 1, 2016, Directive 2009/138/CE, better known as Solvency II Directive, comes into effect for European insurers. This solvency framework is aimed at the supervision of risks, in their prospective dimension, and encourages entities to improve their risk management systems, since it allows the use of internal models in the determination of regulatory requirements.

The regulation improves the consistency of the treatment of the same risks among different sectors to avoid sectoral arbitrage between them, promotes international convergence and is flexible and efficient from the perspective of supervision since it does not necessarily demand a greater capitalization of the sector, but rather the discrimination of the capital requirement according to the risk profile they show.

The companies under the Solvency II Directive must be analysed from the point of view of the regulatory capital requirements according to the Solvency Capital Requirements (SCR) under Pillar I of the directive.

There are two main factors to consider in the stand-alone assessment, both quantitative:

First, the Solvency Capital Requirements (SCR) is defined as the set of assets necessary to guarantee the coverage of technical provisions over a year with a confidence level of 99.5%, that is, adjusted to a probability of ruin 1 time every 200 years. The SCR is the objective capital that the entity must maintain under normal conditions and that will require an action plan if it falls below the required levels, but without assuming immediate intervention by the supervisor.

The SCR cannot be considered in isolation from the technical provisions since both concepts are part of a consistent general framework, aimed at ensuring compliance with the commitments acquired with the policyholders.

Secondly, the Own Funds, that is, the excess of capital that results after liabilities are deducted from total assets. Solvency II considers market valuations in determining the own funds available to the company. These own funds consist of equity and debt instruments classified as level 1, 2 and 3 capital, depending on their characteristics. Basic own funds are understood as the excess of assets over liabilities and subordinated liability instruments, while the rest of own funds are those that are not classified as basic (complementary) but that can be used to absorb losses with the prior approval of the supervisory authorities.

Sources of Information

In our analysis, the methodology is designed to allow us to rate companies with publicly available information. The indicators used are common and global to the insurance industry, facilitating the availability of information. In addition, the information provided by the client, which is treated confidentially, can also be used when necessary and available. Throughout the methodology we have established alternatives to improve the quality of information when any of these indicators are not available or can be improved in our analysis through similar metrics or additional adjustments.

5. Assessment of key factors

Table III summarizes the categories with their key performance indicators applied to a specific example (scorecard). From now on, the meaning of each one will be detailed, its relevance when the insurance company is analysed, as well as the scale to be considered to specify the measurement of each indicator.

Table III: Scorecard example

					Final score
INSURER XYZ					3,75
		Data	Score	Weight	Subtotal
MACRO & SECTORIAL ENVIRONMENT	Very strong -			15,0%	0,50
Sovereign risk				5,0%	0,10
Sovereign rating		AA	2	5,0%	**0,10**
Regulation				5,0%	0,15
Prudential regulation		3	3	5,0%	**0,15**
Sector dynamics				5,0%	0,20
Sector strength		4	4	5,0%	**0,20**
COMPANY PROFILE	Strong -			45,0%	2,00
Business model				15,0%	0,68
Diversification		5	5	8,0%	**0,40**
Distribution channels		4	4	7,0%	**0,28**
Positioning				10,0%	0,45
Market share		8,4%	5	5,0%	**0,25**
Peer Analysis		4	4	5,0%	**0,20**
Management & Risk profile				20,0%	0,87
Risk profile		4	4	7,0%	**0,28**
Governance		5	5	7,0%	**0,35**
Brand		4	4	6,0%	**0,24**
FINANCIAL PROFILE	Strong			40,0%	1,30
Earnings & Profitability				15,0%	0,50
ROA		0,6%	3	5,0%	**0,15**
ROE		8,6%	3	5,0%	**0,15**
Combined ratio		88,4%	4	5,0%	**0,20**
Capitalization & Leverage				15,0%	0,45
Fixed charge coverage ratio		11,2	1	2,5%	**0,03**
Net earned premiums to equity		96,4%	6	5,0%	**0,30**
Regulatory capital ratio		225,6%	2	5,0%	**0,10**
Financial leverage ratio		7,9%	1	2,5%	**0,03**
Liquidity				10,0%	0,35
Liquid assets to policyholder liabilities		47,2%	3	5,0%	**0,15**
Asset liability management		4	4	5,0%	**0,20**

*Source: EthiFinance Ratings

As can be seen, each category is given a weight in percentages which add up to 100%. This distribution of weights includes the quantitative criteria necessary in the analysis of an insurance company. This facilitates comparison between entities operating under different legislation, in different regions or with different business combinations. In addition, the scorecard is complemented by a qualitative analysis reflecting positive or negative trends. Taking this analysis into account, a final rating is obtained that accurately reflects the opinion of EthiFinance Ratings.

5.1 Operating Environment

The main elements of this category are:

1. Sovereign risk
2. Regulation
3. Sector dynamics

Why is the assessment of this category important?

The operating environment of the company influences its financial strength because a robust regulatory supervision directed at monitoring business strategies protects insurance consumers and policyholders. In addition, sovereign risk may limit the company's rating because there is a close relationship between the company's investment portfolio and the sovereign debt of the country of origin.

EthiFinance Ratings considers that the sovereign risks where the company operates, the particularities of the insurance sector in that region and the regulatory framework applied to it are initial factors that may constrain the insurance company's performance and, consequently, the strength of the other categories such as its financial and business profile.

This category considers factors related to the strength of the economy and the sovereign debt profile, as well as aspects related to the rule of law and market penetration of the insurance system. A company that operates in regions with sustainable public finances, where the legal framework guarantees the socio-economic relations of its citizens and the insurance sector has high levels of penetration and efficiency, will have the fundamental factors for an adequate rating due to the existing link between sovereign and investment risk.

The analysis of the macroeconomic and jurisdictional environment considers all regions in which the insurance company has a significant share of business. Likewise, the stability of its currency and the political and social stability of the region are considered for the analysis. The objective of the regulation must be evaluated according to the degree of protection of the insurance consumers and policyholders. Therefore, the Solvency II Directive is a fundamental pillar for the regulator, since it requires minimum capital standards, defines a management policy that minimizes risks and details financial information requirements.

5.1.1 Sovereign Risk: Sovereign Rating

The main factor of this section is sovereign risk of the countries where the company operates:

a. Sovereign rating

Sovereign rating	
Rating	Score
≥AA+	1
≥AA-	2
≥A	3
≥BBB+	4
≥BBB-	5
≥BB	6
≥B+	7
≥B-	8
≥CCC	9
≤CCC-	10

*Source: EthiFinance Ratings

Sovereign rating determines the capacity of the government to meet its payment obligations and maintain fiscal, commercial and employment stability. The sovereign's ability to influence the financial system, as well as the relationship between sovereign risk and financial risk (through the exposure to its debt markets) makes the financial sector particularly sensitive.

A sovereign with a weak credit rating is the result of a deteriorating economy that also needs intervention to smooth out imbalances, putting additional stress on the government. This deterioration would have an impact on the insurance sector's investments, increasing their volatility and affecting the value of sovereign and financial assets. Because of that, the sovereign rating may act as a ceiling to the insurance company's rating.

When analysing a global insurance company, the sovereign rating can be determined as the weighted average of the main countries in which the company operates, using a country-specific metric (primarily risk or revenue distribution, if possible) as the weight to obtain the final sovereign rating.

5.1.2 Regulation: Prudential Regulation

The main factor of this section is the following:

a. Prudential regulation

The legal context of the insurance system in the region, or regions, where it operates is a relevant aspect in the assessment of the insurance company. Therefore, as with sovereign risk, when it is a global insurer, the weight of each region within the group will be taken into account when assessing this block. This section considers the level of legal sophistication of the region, its transparency, the system's ability to enforce contracts and the effectiveness in the application of all legislation. In addition, the accounting standards applicable to the region, its stability and its ability to reflect the financial and economic situation of the financial institution are considered.

Insurance companies promise payments to policyholders on the appearance of an insured event; therefore, it is essential to show a solid financial profile to the market. The regulatory supervisor is an important agent in its role as a prudential authority in anticipation of the requirements that all insurance companies must meet in order not to jeopardize the interests of policyholders. Despite maintaining common elements, there are differences between the different insurance sectors.

In the case of general insurers, capitalization levels are usually adequate, with a financial performance conditioned by products that are sometimes required by law, which gives them some income stability. They generally show a portfolio of high-quality investments. However, a key factor for the good performance of life insurers is the underwriting cycle, where high competition causes the supply of insurance to rise, reducing its price and, finally, driving out competitors who do not adapt to the new market scenario. By decreasing the number of competitors, prices return to previous levels. This underwriting risk needs to be managed together with other performance factors such as the profitability of the investment portfolio or the ability to release surpluses related to loss reserves.

In the case of life insurers, there are common elements to general insurers, such as diversity in business profiles, adequate capitalization, and a portfolio of good quality investments. Most of the products sold by life insurers are future long-term payment commitments with cash flows of certain predictability and reduced retirement risk, so that they can retain investments in the face of market shocks and adapt the offer to the new scenario.

Prudential regulation	
Score	Description
1-2	Regulatory environment highly developed and transparent. Very effective application of current legislation and regulation.
3-4	Regulatory environment highly developed and transparent. Application of current legislation and regulation.
5-6	Regulatory environment less developed and acceptable level of transparency. The application of legislation and regulation may be less effective or transparent.
7-8	Regulatory environment is in development. Financial reporting and regulatory application shows less transparency.
9-10	Regulatory environment in the process of development and with minimum transparency. Application of legislation and regulation with difficulties. Reporting and regulatory execution lacking transparency.

*Source: EthiFinance Ratings

5.1.3 Sector Dynamics: Sector Strength

The main factor of this section is the following:

a. Sector strength

In addition to sovereign risk and regulation, at EthiFinance Ratings we also assess, within the operating environment, the strength of the sector in the performance of its activity from different perspectives.

From our point of view, the strength of the sector depends on the ability of insurance companies to carry out their activity by exhibiting high profitability without taking on excessive risk. Thus, elements such as the penetration of the insurance sector in the economic activity of a country, the potential growth of premium underwriting in the insurance lines where a company is present, the ability of companies to set prices, the existence of limited competition both within and outside the industry with alternative products or the interest rate environment are important in the credit profile of an insurer.

Sector strength	
Score	Description
1-2	The insurance market is highly developed and the utility of the product is very well perceived. Competition in the industry is limited and companies enjoy strong price-setting power. Economic policies are very supportive of making profits in the sector.
3-4	The insurance market is developed and the utility of the product is well perceived. Competition in the industry is limited in some products and companies enjoy low price-setting power. Economic policies are supportive of making profits in the sector.
5-6	The insurance market is developing and the utility of the product is well perceived. Competition in the industry is moderate and companies are price-takers. Economic policies are profit-neutral in the sector.
7-8	The insurance market is developing and the use of the product is limited. Competition to attract customers is high and companies are price-takers. Economic policies are not favorable for making profits in the sector.
9-10	The insurance market is limited and the utility of the product is unknown. Companies must offer low prices to underwrite policies. Economic policies are limiting the sector's profitability.

*Source: EthiFinance Ratings

5.2 Company Profile

The main elements of this category are:

1. Business model
2. Positioning
3. Management and risk profile

Why is the assessment of this category important

This category analyses an insurance company's business model, given that its strategy is constrained by its risk appetite and franchise strength.

A fundamental element in this category is the diversification of the company in terms of business lines, where the distribution channel is of special importance. Diversification understood in the broadest sense contributes to the stability of income and the maintenance of an adequate financial structure throughout the cycle. A high concentration in any single business line increases the vulnerability of the insurer to market shocks or regulatory events.

In the positioning section, peer analysis is particularly relevant. The assessment of the region's main competitors is fundamental in anticipating market trends as well as identifying possible strengths or weaknesses. The competitive strength of an insurance company can affect the ability of the company to maintain a certain level of financial performance in its key business lines and, therefore, affect its financial strength. It is essential to maintain certain levels of operational efficiency, which will be favoured by the size of the company. However, it is important to analyse the leverage that the company has incurred to achieve a large size, so that growth is not always linked to a competitive advantage.

Additionally, the strength of the brand is the result of the diligent development of the insurance activity with the client, reflecting an adequate management of current businesses and the ability to attract new businesses. The relationship of the brand with a quality-based offering can give the company a good reputation that acts as a barrier to entry for potential competitors within its business lines. This reputation has its origin in effective corporate governance, independent of the individual interests of the members and with adequate monitoring of the risks to which the company is exposed.

5.2.1 Business Model: Diversification and distribution channels

The main factors of this section are the following:

a. Diversification

A portfolio of diversified products or lines of business in a wide array of countries should reduce the volatility of revenues and adjust exposure to certain markets for better risk management and more efficient use of the company's capital. In addition, an insurance company with a diversified product portfolio has a greater ability to adapt to possible changes in the needs of current or potential customers and changes that may occur in the market.

Diversification should not only be understood as having different lines of business or being present in multiple countries. We also consider the degree of interrelation among these products over the economic cycle, or the potential synergies obtained between diversified businesses. For example, an insurer with three lines of business and present in several countries in the same regional area that behaves in a similar way over the business cycle, i.e., with a high correlation, would not exhibit high quality diversification despite its multiple businesses.

Diversification	
Score	Description
1-2	Very high level of diversification between business lines and geographies. Diversification of the business contributes very positively to income stability throughout the cycle. Very high capacity of the company to attract and retain business.
3-4	High level of diversification between business lines and geographies. Diversification of the business contributes positively to income stability throughout the cycle. High capacity of the company to attract and retain business.
5-6	Moderate level of diversification between business lines and geographies. Diversification of the business contributes in a limited way to income stability throughout the cycle. Moderate capacity of the company to attract and retain business.
7-8	Insufficient level of diversification between business lines and geographies. Diversification of the business doesn't contribute to income stability throughout the cycle. Insufficient capacity of the company to attract and retain business.
9-10	Neither business nor geographical diversification. Insufficient capacity of the company to attract and retain business.

*Source: EthiFinance Ratings

b. Distribution channels

Insurance companies need solid channels through which to distribute their products. In certain markets, the relationship between the insurance sector and the banking sector is very close thanks to the bank's ability to penetrate the market through its extensive branch network.

Likewise, this linkage is established through majority stakes in the insurance company, minority stakes but with banking-insurance distribution agreements or through significant stakes in insurance companies. This relationship becomes more visible especially in the life insurance sector. However, there are other means of distribution such as insurance agents, brokers and other mediators and insurance operators.

The company's control over a distribution channel is a key element. Distribution channels that favour customer retention or are more profitable have a more positive credit profile.

Distribution channels	
Score	Description
1-2	Sales take place through controlled distribution channels that can be used for reinsurance business. Direct sales have a strong position in the market and represent a competitive advantage over third parties. The company's products obtain robust sales in its niche market.
3-4	Sales take place through intermediated distribution channels that can be used for reinsurance business. Direct sales have an adequate position in the market and represent a competitive advantage over third partie The company's products obtain high sales in its niche market.
5-6	Sales take place through intermediated distribution channels. Direct sales don't represent a significant percentage. Sales can show a certain concentration in a particular distributor.
7-8	Sales take place through a limited series of intermediated distribution channels. Low penetration in the market through the weak distribution channels used. Excessive dependence on a specific distributor.
9-10	Sales take place through a limited and weak series of intermediated distribution channels. Excessive dependence on a specific distributor and insufficient penetration in the market.

*Source: EthiFinance Ratings

5.2.2 Positioning: Market Share and Peer Analysis

The main factors of this section are the following:

a. Market share

The market share of an insurance company is based on the strength of its main business lines and its ability to retain its customers.

Market share can be measured at the regional, national or country level, depending on the type of insurance company. The relevant markets for insurance activity may include competitors that are not in the same sector (life and non-life insurance companies) but compete with them in some products. A robust positioning in the market means a wide customer base and, consequently, greater stability in its business.

Market share	
Score	Description
1-2	Dominates the market in a wide range of business lines (market share ≥ 17%). Market position and solid pricing power without threat from competitors. Leads the number of products per customer share.
3-4	It is one of the main agents of the market, but it does not manage to lead it (market share ≥ 11%). Product market share pers customer is high or leads the sales of a niche product.
5-6	Maintains a good market position at regional or national level despite not being among the first in the market (market share ≥ 4%) or leads the market share of a product, without dominating it.
7-8	Little market share at regional or national level (market share ≥ 2%) Customer base can be highly volatile.
9-10	Insignificant market share (market share 2%). Irrelevant positioning in the market.

*Source: EthiFinance Ratings

b. Peer analysis

Peer comparison
Gross Written Premiums
Return on Assets
Return on Equity
Combined ratio
Total Equity
Regulatory Capital
Financial Leverage

*Source: EthiFinance Ratings

The purpose of the peer analysis is to establish an overview of the company's economic performance as well as of its financial strength in a regional, national or international environment.

The peer analysis is performed by analysing seven blocks. Stock performance is also considered in case of listed companies. The comparative analysis is performed with insurance companies operating in the same region or with a similar business mix.

5.2.3 Management and Risk Profile: Governance, Risk Profile and Brand

The main factors of this section are the following:

a. Governance

The shareholder structure of an insurance company can be assessed according to the type of ownership: state, institutional / corporate, family, publicly listed and mutualized. Normally, each type of shareholding structure has a specific corporate governance profile (conflicts of interest or shareholder value), but the aim is always to protect creditors through a rigorous transparency policy. The stability and influence of its shareholders, the separation of interests (individual from creditors) and the frequency in the reporting of its financial statements are aspects positively valued.

b. Environmental, Social and Governance

In addition, EthiFinance Ratings maintains its commitment to ESG (Environmental, Social and Governance) through which it intends to measure the sustainability and ethical impact of the entity's investments and its relationships with its clients, as well as its management of employees. There are lots of environmental and social issues that impact the insurance sector. All insurance companies have an important role to play in leading the challenges by helping their customers achieve financial security. We think ESG's implementation generates value for shareholders, customers and the sector in which insurance companies operate.

Insurers can be impacted by environmental issues such as climate change in several ways. Firstly, shifts in weather patterns could increase catastrophic events affecting their loss ratio. Secondly, insurers have a high volume of financial investments that include exposure to industries with high environmental risks such as oil, gas and utilities. In addition, some insurance lines such as credit insurance are also exposed to these industries in their underwriting activity. The ability to manage these risks should be a strength of the industry.

All insurance companies must monitor and reduce their environmental footprint, to ensure effective and ethical governance and invest in ways that stimulate sustainable economic growth. Although reputational risk, financial risks and legal risks are cross-cutting factors that affect the company's financial profile, EthiFinance Ratings takes them into account when measuring the quality of its corporate governance.

Governance	
Score	Description
1-2	Corporate governance is very strong and provides a solid protection of the policyholders. Board supervision is very effective. Financial statements are reported with high quality and frequency. Very effective implementation of ethical and sustainable governance policies.
3-4	Corporate governance is good and provides fair protection of the interests of policiyholders. Board supervision is effective. Financial statements are reported with good quality and frequency. Effective implementation of ethical and sustainable governance policies.
5-6	Corporate governance is less developed than other better qualified peers. This scenario doesn´t present additional risks. The entity implements ethical and sustainable governance policies without guarantees of its effectiveness.
7-8	Corporate governance creates risks for creditors due to weak supervision by the board, low quality reporting or intra-group transactions. Governance policies on ethics and sustainability are not implemented.
9-10	Corporate governance creates high risks for creditors due to very weak supervision by the board, substantial accounting failing or large intra-group transactions. The absence of any control in the ethical aspect of its corporate policy generates substantial risks for the entity.

*Source: EthiFinance Ratings

c. Risk profile

Risk profile	
Score	Description
1-2	Highly effective risk policies. Excellent management profile. Limited attributes of a weak risk profile.
3-4	Effective risk policies. Good management profile. Some attributes of a weak risk profile.
5-6	Adequate risk policies. Ineffective management profile. Some attributes of a weak risk profile.
7-8	Ineffective risk policies. Weak risk profile.
9-10	Very ineffective risk policies. Weak risk profile.

*Source: EthiFinance Ratings

Given the specific features of the insurance companies, they are obliged to evaluate risks. The exposure to the different risks inherent to the insurance activity and the risk management that the company has carried out over the years are the fundamental elements that EthiFinance Ratings evaluates, paying special attention to the management of credit risk, market risk, interest rate risk and operational risk.

d. Brand

Brand strength is a fundamental element in the activity of insurance companies because it can be the result of good management of both, their customer relationship and their economic-financial results. A company with stable customer management can benefit from greater loyalty and a greater capacity to expand its customer base.

Therefore, a solid brand image provides visibility to the business, which reduces the likelihood of future reputational risks and generates competitive advantages over the competitors.

Brand	
Score	Description
1-2	Brand with a very good reputation in all business segments and regions where it operates. Competitive advantages and proven pricing power are able to maintain in the long term.
3-4	Brand with a good reputation in all business segments and regions where it operates. Competitive advantages and proven pricing power are able to maintain in the long term.
5-6	Brand with an adequate reputation in the main business segments and regions where it operates. Competitive advantages and pricing power are limited.
7-8	Brand with a moderate reputation in the main business segments and regions where it operates. Reputational risk is high. It operates in some less developed insurance markets with limited competitive advantages and pricing power
9-10	Brand with a objectionable reputation. It operates in undeveloped insurance markets without competitive advantages.

*Source: EthiFinance Ratings

5.3 Financial Profile

The main elements of this category are:

1. Earnings & Profitability
2. Capitalization & Leverage
3. Liquidity

Why is the assessment of this category important

The financial profile of an insurance company is a key category in the credit profile analysis because, in addition to the typical aspects of this category, it often includes the influence of the company's environment and management.

The three elements of this category are earnings and profitability, capitalization and leverage and liquidity. The analysis also evaluates the stability and trend of its metrics and its forward-looking expectations. The data considered for the evaluation is the latest available or the average of the last 2 or 3 years. However, in some circumstances, the range of data used can be increased for individual indicators or for an entire company. For example, in ratios that are particularly sensitive to the economic cycle, such as the combined ratio, the period used can be extended to capture the different phases of the cycle. Also, in insurance companies of limited size or with a shorter financial history, whose results tend to be more volatile, a longer number of years may better reflect the company's credit risk.

An insurance company that shows predictable results over the cycle and is consistent with its risk profile will have a better solvency profile, which will translate into a high rating.

In addition, a company’s capital provides a cushion for policyholders and other creditors, allowing the company to absorb adverse deviations from expected forecasts, and represents an important part of an insurance company's financial strength. Regulatory capital measurements under Solvency II are considered the most robust indicator of a company's level of capitalization.

The liquidity assessment considers the characteristics of the main assets and liabilities, the frequency and severity of the claims and the availability of liquid resources, among others. The company may suffer losses if it is forced to sell assets at a discount to meet policyholders’ demands.

The main sources of information used by EthiFinance Ratings are audited financial statements together with other public information reported to the supervisor. For solicited ratings, unaudited interim financial statements (monthly, quarterly, and semi-annual) will be used. In addition, further private information such as management reports, strategic plans, and all types of institutional information for investors may be required.

The financial analysis is always adapted to the idiosyncrasies of the company. In particular cases, other metrics can be used besides those indicated in this methodology or, if appropriate, metrics can be adjusted for a specific case.

5.3.1 Earnings & Profitability

The main metrics of this section are the following:

a. Return on assets

ROA	
%	Score
≥2,00	1
≥1,00	2
≥0,55	3
≥0,45	4
≥0,30	5
≥0,15	6
≥0,10	7
≥0,05	8
≥0,00	9
<0,00	10

*Source: EthiFinance Ratings

RoA is defined as net income of the exercise divided by the average total assets of the last two years. This ratio measures the company's ability to generate earnings relative to the size of its assets. Therefore, the higher RoA, the better the rating.

The RoA considers the equity and the rest of the obligations contracted. However, an excessively leveraged financial structure would have a negative impact on RoA, as it would be constrained by higher financial expenses. An efficient balance sheet structure generates RoA rates above financial cost of its debt.

b. Return on equity

ROE	
%	Score
≥12,50	1
≥10,00	2
≥8,00	3
≥6,70	4
≥5,00	5
≥3,00	6
≥1,00	7
≥0,50	8
≥0,00	9
<0,00	10

*Source: EthiFinance Ratings

RoE is defined as net income divided by the average equity of the last two years. This ratio measures the company's ability to generate earnings with its equity. The higher the RoE, the better the insurance company's rating will be, since a greater internal capital generation will lead to a greater return to shareholders.

However, both RoA and RoE can be affected by non-recurring items that would impact the calculation of both ratios. Therefore, these ratios should be adjusted by eliminating these items from their calculation to obtain a normalized metric (without extraordinary items). This may be the case for the RoE when the company makes share buybacks or distributes high dividends. However, this improvement in RoE would result in an overall decrease in the company's financial strength.

c. Combined ratio

Combined ratio	
%	Score
≤75,00	1
≤80,00	2
≤85,00	3
≤90,00	4
≤94,00	5
≤98,00	6
≤102,00	7
≤106,00	8
≤110,00	9
>110,00	10

*Source: EthiFinance Ratings

The combined ratio is the result of dividing the sum of claims expenses plus operating expenses over accrued net premiums.

Therefore, this ratio can be understood as a combination of the claims ratio (losses incurred by the company net of reinsurance divided by the net premiums for the period) and the expense ratio (operating expenses divided by net premiums of the period).

A combined ratio of less than 100% indicates a strength in the company's structure. Lower combined ratios are necessary for companies that underwrite short tail lines and generate moderate levels of investment income, or those whose policies are exposed to periodic catastrophes or other large losses.

5.3.2 Capitalization & Leverage

The main metrics of this section are the following:

a. Fixed charge coverage ratio

Fixed charge coverage ratio	
x	Score
≥12,00	1
≥9,00	2
≥6,00	3
≥4,00	4
≥3,00	5
≥2,00	6
≥1,00	7
≥0,50	8
≥0,00	9
<0,00	10

*Source: EthiFinance Ratings

The fixed charge coverage ratio is an indicator of interest service and is calculated on a consolidated basis, dividing the EBIT or operating earnings, excluding realized and unrealized gains and losses or one-off events by total interest expense plus the amount of tax-adjusted dividends of preferred shares. Therefore, the higher the value of the ratio, the greater the capacity to face the debt service and the greater the insurer's flexibility.

Additionally, the coverage indexes are also calculated to reflect the restrictions for dividends of regulated entities.

b. Net earned premiums to equity

Net earned premiums to equity	
%	Score
≤45.00	1
≤55.00	2
≤65.00	3
≤75.00	4
≤90.00	5
≤105.00	6
≤120.00	7
≤140.00	8
≤160.00	9
>160.00	10

*Source: EthiFinance Ratings

Net earned premiums to equity are net premiums written after reinsurance divided by equity or policyholder surplus. Policyholder surplus is the difference between assets and liabilities. This ratio is used to measure the ability of an insurance company to underwrite new policies.

The greater the policyholder surplus, the greater the assets are compared to liabilities. Liabilities are the benefits that the insurer owes its policyholders. The insurer is able to increase the gap between assets and liabilities by effectively managing the risks associated with underwriting new policies, by reducing losses from claims, and by investing its premiums in order to achieve a return while maintaining liquidity. As long as the insurer has more assets than liabilities, it will be able to underwrite new policies. While each new policy increases the insurer's overall liabilities, it also increases the amount of premiums the insurer will receive from policyholders.

In general, a low premium to surplus ratio is considered a sign of financial strength because the insurer is using its capacity to write more policies. When premiums increase without a corresponding increase in policyholders' surplus, the capacity of the insurer to write new policies decreases.

This ratio indicates the net operating leverage of a company over the currently subscribed business and measures the equity exposure to price errors. Given that net written premiums depend both on volume and price, the interpretation of the ratio should be prudent since an adverse reduction in the volume of premiums could lead to apparent improvements in the ratio.

Additionally, some adjustments can be made to the scoring of this ratio when a company frequently relies on reinsurance contracts. Although the reinsurer is responsible for the reinsured risks, any default by the reinsurer may result in the obligation of the company to cover these claims.

c. Regulatory capital ratio

Regulatory capital ratio (SCR)	
%	Score
≥230.00	1
≥210.00	2
≥190.00	3
≥170.00	4
≥150.00	5
≥130.00	6
≥120.00	7
≥110.00	8
≥100.00	9
<100.00	10

*Source: EthiFinance Ratings

The regulatory capital ratio used under Solvency II is called the Solvency Capital Requirement (SCR) defined as the set of assets necessary to guarantee the coverage of technical provisions over a year with a confidence level of 99.5%, that is, adjusted to a ruin probability of 1 time every 200 years.

The SCR is the objective capital that the entity must maintain under normal conditions and if it is below the required levels, it will require an action plan, but this does not imply immediate intervention by the supervisor.

There are some additional elements that can be used to adjust this metric. First, the capital structure of the company. An insurer with a capitalization composed exclusively of tier 1 instruments is stronger than an insurer with a considerable share of tier 2 instruments. Likewise, the use of standard models to calculate risks tends to be a more conservative approach to calculating the company's solvency.

d. Financial leverage ratio

Financial leverage ratio	
%	Score
≤10,00	1
≤20,00	2
≤20,00	3
≤40,00	4
≤50,00	5
≤60,00	6
≤70,00	7
≤80,00	8
≤90,00	9
>90,00	10

*Source: EthiFinance Ratings

The financial leverage ratio is defined as debt (including hybrid instruments and preferred shares) divided by the company's equity. Therefore, the lower the value of the ratio, the better the financial soundness of the company. In some cases, some types of debt could be excluded for the calculation of the ratio because they are considered as operational only.

In addition, the asset quality must be analysed, taking into account the origin of the assets that support it. This measure considers the use of financial leverage within the total capital structure. Likewise, there are additional factors to be considered such as the cost of the debt, the sources of financing and the maturity of the debt. For example, insurers with a well-balanced debt at different maturities and low interest rates have stronger financial flexibility to manage their liabilities.

5.3.3 Liquidity

The main metrics of this section are the following:

a. Liquid assets to policyholder liabilities (life insurance companies)

Liquid assets to policyholder liabilities	
%	Score
≥60,00	1
≥50,00	2
≥40,00	3
≥30,00	4
≥20,00	5
≥15,00	6
≥10,00	7
≥5,00	8
≥2,50	9
<2,50	10

*Source: EthiFinance Ratings

This ratio is defined as the total amount of invested assets readily convertible into cash over the obligations held with policyholders (with the possibility of adjusting for non-redeemable liabilities). Therefore, the higher the value of the ratio, the greater the capacity to meet obligations to the policyholders in case of need.

Life insurers are the ones that have the most exposure to potentially enforceable liabilities and, therefore, are the ones that must have the highest amount of liquid assets over enforceable liabilities.

b. Asset liability Management

Asset and liability management and liquidity risk are important risk factors for insurance companies due to the high leverage of investments, as well as exposure to required liabilities, which makes it necessary to have sufficient cash to cover all obligations.

Strong liquidity is important for life insurers that have a high exposure to liquid liabilities. When life companies have limited liquidity risk, adequate asset liability management is important to achieve profitability objectives and manage interest rate risk.

General insurers typically cover claims by drawing on cash flows from their ordinary business, which reduces the risk of having to resort to the sale of discounted investment positions to cover claims payments. Liquidity becomes more important for general companies in the short-tail insurance sectors and in the event of large catastrophe losses.

Asset Liability Management	
Score	Description
1-2	Excellent ability to support a stressed liquidity environment. Abundant marketable assets over exigible liabilities. Reliable emergency liquidity sources.
3-4	Good ability to support a stressed liquidity environment. Sufficient marketable assets over exigible liabilities. Reliable emergency liquidity sources.
5-6	Limited ability to support a stressed liquidity environment. Limited marketable assets over exigible liabilities. Less reliable emergency liquidity sources.
7-8	Very limited ability to support a stressed liquidity environment. Minimum marketable assets over exigible liabilities. Unreliable emergency liquidity sources.
9-10	Inability to support a stressed liquidity environment. Insufficient marketable assets over exigible liabilities. Insufficient emergency liquidity sources.

*Source: EthiFinance Ratings

6. Support

6.1 Introduction

In this section, EthiFinance Ratings evaluates the support an insurance company can receive from other institutions and the way in which this support fits into the credit rating of the company. Two types of support have been considered: systemic support, understood as that provided by governmental, supranational or similar institutions, and internal support, understood as that provided by institutions related to the company, such as its parent company or other related companies.

The support included in this section is understood from a forward-looking perspective, that is, the support that would exist if the company needed it. Therefore, the fundamental aspects to evaluate in this type of support is the probability that it will be executed in case of need and the company's ability to provide this support effectively. The regulatory framework has the capacity to influence the execution of the support, mainly systemic support.

However, any rating upgrade conditioned by internal/external support will depend on the assessment of the supporter's credit profile.

Internal support is determined by the probability and capacity of the related company to provide future support to the company in case of need. Unlike systemic support, internal support is more common in all jurisdictions. This support will depend on the importance of the insurance company to the rest of the group at an operational level or the reputational damage that could be triggered by a stress scenario.

6.2 Types of Support

The first type is systemic support. In this case, the rating of the insurance company would be improved from one to a maximum of three notches, in the most favourable scenarios.

The second type is internal support, in which the capacity and probability of support from the related companies belonging to the group are analyzed. In this case, the starting point of the rating is the company's financial strength assessment, which could improve or deteriorate in a range of up to three notches, depending on the credit strength of the supporter and its relationship with the rated company.

In addition, the probability of related companies providing support to the company depends on the importance of the entity's activity for all the group's business lines, the existence of a common brand and its presence in similar geographic regions (cross-border risk) should also be considered.

When the rated companies are subsidiaries (domestic or foreign) and there is excessive dependence on the group at the operational level, the credit rating of the supporter (the parent company) is taken as a starting point, with the size/importance of the subsidiary in relation to the Group considered to make the adjustment that may range from 0 to -3 notches.

6.3 Analysis of the Support

In the previous section, we describe the types of internal and external support that the insurance company receives to complete its financial strength assessment. This support is included in the Insurer Financial Strength Rating of the company. The adjustments applied in this process are explained below.

Regarding the ability to provide support, the credit strength of the supporter is the fundamental element for this evaluation, so its credit rating would be considered. If this rating is based on consolidated financial statements, appropriate adjustments would be made to produce proforma consolidated statements of the supporter isolated from the insurance company receiving this support.

Assessing the probability of execution in case of need considers aspects such as the degree of control that the supporter has on the company, that is, if it is its sole shareholder, a minority partner or holds an indirect relationship. It is also important to know of the existence of any legal support between both entities that guarantees this support and of the strategic importance and the financial links that could exist and that would make it difficult for the supporter to allow its subsidiary to fail.

Finally, operating in the same region or under the same brand is a link that, despite being an intangible consideration difficult to assess, shows a connection between the company analyzed and the supporter and a mechanism for transmitting reputational risks that could affect the supporter.

This document updates the previous version while preserving its original methodological criteria; therefore, all existing ratings remain unchanged. In this version, the format has been updated and includes a higher level of detail.