

# RatingsDirect®

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## HCC Insurance Holdings Inc.

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# HCC Insurance Holdings Inc.

## Major Rating Factors

Strengths	Weaknesses
<ul style="list-style-type: none"><li>• Very strong competitive position due to diversified noncorrelated business units and demonstrated expertise in its business lines</li><li>• Robust earnings with a record of outperforming specialty peers throughout underwriting cycles</li><li>• Very strong capital adequacy with a supportive parent to maintain capital at current levels</li></ul>	<ul style="list-style-type: none"><li>• Potential earnings volatility from growing crop exposure and changes to government support</li></ul>

## Rationale

S&P Global Ratings' ratings on HCC Insurance Holdings Inc. (HCC) and its insurance operating subsidiaries (collectively, TMHCC) reflects the group's very strong business risk and financial risk profiles. Our ratings benefit from TMHCC's strong market presence in focused niches, noncorrelated business mix, leading consistent underwriting results with a strong record of outperforming the industry, lower volatility in underwriting margins, and strong premium growth without compromising underwriting standards. It boasts a strong balance sheet with support from the parent's larger balance sheet if needed and redundancy at the very strong level to weather volatility in markets and/or natural catastrophe losses. We applied a one-notch holistic adjustment to the 'aa-' anchor due to TMHCC's long-standing stable record of superior operating performance with very low volatility, bringing the stand-alone anchor to 'aa'.

We consider TMHCC highly strategically important to parent Tokio Marine Group. But we view it as an insulated subsidiary due to its independence from the Tokio Marine Group, regulatory restrictions on extraordinary dividends, and its stand-alone strength. We assigned our ratings based on TMHCC's stand-alone credit profile, leading to a rating one notch higher than those on Tokio Marine.

**Outlook: Positive**

The positive outlook on TMHCC is consistent with that on the core and guaranteed operating subsidiaries of Tokio Marine & Nichido Fire Insurance Co. Ltd. (TMNF). The outlook reflects our expectation that TMHCC will maintain very strong capital and earnings through superior underwriting discipline with no material change in its overall risk profile. It also reflects the potential for a possible Japanese sovereign upgrade, which would result in both the parent and TMHCC also being upgraded if its stand-alone credit fundamentals do not change. We expect TMHCC to operate independently from the group, so we will continue to view it as an insulated subsidiary of Tokio Marine.

**Downside scenario**

We could lower the ratings in the next 24 months if TMHCC's stand-alone credit characteristics deteriorate, we lower our ratings on the core and guaranteed operating subsidiaries of Tokio Marine, we no longer view TMHCC as an insulated subsidiary due to increased integration or dependence on the group, or capital adequacy weakens to below the 'AA' level for a sustained period.

**Upside scenario**

We could raise our ratings on TMHCC's if we raise our sovereign rating on Japan and TMHCC maintains its stand-alone credit fundamental strength. But we could revise the outlook to stable in conjunction with a revision in our outlook on Japan.

**Macroeconomic Assumptions**

- Real U.S. GDP growth of about 2.9% and 2.6% in 2018 and 2019
- 10-year Treasury rate at about 3.1% in 2018 and 3.4% in 2019
- Core Consumer Price Index at 2.5% in 2018 and 1.9% in 2019
- Unemployment rate at 3.9% in 2018 and 3.6% in 2019
- Stable industry economic outlook for property/casualty (P/C) insurers

**Key Metrics**

(Mil. \$)	--Year ended Dec. 31--					
	2019*	2018*	2017	2016	2015	2014
Total revenue	3,800-3,900	3,700-3,800	3,444	3,228	3,025	2,586
S&P Global Ratings' capital adequacy/redundancy	AA	AA	AA	AA	AA	AA
Net combined ratio (%)	87-89	87-89	89.0	87.6	86.1	82.5
Financial leverage (%)	18-20	18-20	19.2	18.8	19.7	17.5
EBITDA fixed-charge coverage (x)	>20	>20	23.9	44.9	12.5	20.5

\*Forecast data reflect S&P Global Ratings' base-case assumptions.

## **Business Risk Profile: Very Strong**

TMHCC's very strong business risk profile is supported by its diversified profile that limits volatility and positive operating performance vis-à-vis peers throughout underwriting cycles. Its diversification stems from its focus on noncorrelated specialty insurance products split between P/C--68% of gross premiums written (GPW)--and accident and health (A&H)--roughly 32% of GPW. It underwrites most of its business in the U.S. (greater than 75% of GPW) with the rest coming primarily from Europe. The group has historically expanded its product lines through small acquisitions of underwriting teams and agencies that specialize in targeted products. The most recent notable acquisitions include: AIG's medical stop-loss business; Producers Ag Insurance Group Inc.; International Ag Insurance Solutions LLC; On Call International LLC, a provider of travel risk management services; and Bail USA Inc., a writer of federal and state bail bonds. For newer product lines, TMHCC uses significant quota-share reinsurance coverage and retains more of the risk as the lines season, allowing it to maintain low earnings volatility.

TMHCC has a record of superior underwriting results that have consistently outperformed peers. It had a five-year (2013-2017) average generally accepted accounting principles (GAAP) combined ratio of 85.8%--far better than the average of the P/C industry. TMHCC bases its underwriting compensation practices on profitability, fostering its ability to maintain the quality of business despite its decentralized underwriting approach. Each business unit makes independent risk-selection and pricing decisions. We believe TMHCC's strong underwriting expertise and pricing discipline will sustain its very strong competitive position, and that its acquisition by Tokio Marine will provide additional growth opportunities as policyholders learn more about its product offerings.

We expect the A&H segment to remain a highly important source of revenue and earnings for the group. HCC Life Insurance Co. is one of the largest writers of medical stop-loss insurance in a relatively fragmented market, bolstered by the integration of the AIG medical stop-loss business. The segment's key competitive advantages are its long-standing specialized expertise with the product, good knowledge of the market, highly stable and experienced management team, and its disciplined underwriting approach that allows it to navigate difficult market conditions such as elevated frequency and severity loss trends currently affecting the industry.

## **Financial Risk Profile: Very Strong**

We view TMHCC's capital and earnings as extremely strong due to stable underwriting margins and consistent investment income from its relatively conservative investment portfolio. We expect TMHCC to maintain at least very strong capital adequacy of at least 10% above the 'AA' level per our risk-based capital model. It can adjust its dividend and acquisition strategy to keep capital at committed levels. TMHCC has long had very strong operating performance, supported by superior underwriting results, not only consistently outperforming peers, but also sustaining underwriting performance regardless of market cycles, catastrophes, and a sluggish economic recovery. TMHCC also uses significant reinsurance to mitigate these exposures and has generally conservative loss reserves to support them. Although the group has entered some new lines, we don't expect any material change in its overall risk profile that could compromise its long-term underwriting profitability.

At year-end 2017, TMHCC's \$7.2 billion investment portfolio had a relatively conservative allocation: 85.7% fixed income, 6.2% in cash and short-term investments, 5.3% in loans, and 2.8% in equity and other. The fixed-maturity portfolio is of strong credit quality with an average rating of 'AA-'.

TMHCC has adequate financial flexibility, in our view, that reflects its proven record of access to capital markets, relatively conservative capital structure, strong ability to service financial obligations, and use of reinsurance from highly rated reinsurers partly offset by its inability to access the equity markets without the parent. We expect TMHCC to maintain a conservative capital structure in line with its average historical leverage at or below 20% and coverage above 20x.

## Other Assessments

We view TMHCC's enterprise risk management (ERM) framework as strong based on our positive scores for its risk culture, risk controls, and strategic risk management. The group is well diversified in noncorrelated segments, such as A&H. This diversification helps mitigate exposure to severity risks in its specialty lines, but the complexities of the risk makes ERM of high importance to the ratings. We base our positive view of risk-management culture on its seasoned governance policies and its long-standing enterprise risk committee providing strong oversight. TMHCC has established risk appetite and risk tolerance statements at enterprise risk levels. Its proven record of superior underwriting results, optimized capital allocation, and risk/reward trade-offs shows the strengths of the ERM program. TMHCC uses risk-adjusted return on capital, allocates required capital to its various lines, and optimizes its use of capital. It also uses its return on tangible book value as a measure of performance, enhancing its return profile within its tolerances. TMHCC's control environment includes a compensation system based on underwriting profits, limits by segment and insureds, and reinsurance for new lines until they reach maturity. TMHCC has a low appetite for catastrophe risk and low tolerance for reserve risk as shown by its consistent history of favorable reserve development and average catastrophe losses of less than two points of the combined ratio.

We view TMHCC's management and governance practices as strong and the team as having broad experience. Management benefits from a flat structure, which keeps costs down and provides for quicker decision-making. We expect TMHCC to keep its operational independence and deliver sound financial performance. Its underwriting strategy remains decentralized--with corporate oversight, each business unit enjoys independent decision-making and is considered an individual profit center. TMHCC maintains underwriting discipline by rewarding underwriters based on profitability. It also maintains control through acquisition of underwriting intermediaries and effectively using reinsurance to mitigate risk on less-seasoned lines of business--helping to maintain strong earnings with low volatility.

## Other Considerations

### Accounting considerations

HCC ceased to be listed as a publicly traded entity upon close of the 2015 merger transaction, when it became an indirect wholly owned subsidiary of Tokio Marine Holdings Inc. It continues, however, to prepare quarterly nonpublic consolidated GAAP financial statements for its parent. HCC's U.S.-domiciled insurance subsidiaries file financial statements with state insurance regulators prepared in accordance with statutory accounting principles.

## Rating Score Snapshot

Holding company rating	A-/Positive/--
Financial strength rating	AA-/Positive
Stand-alone credit profile	aa
Anchor	aa-
Business risk profile	Very strong
IICRA	Intermediate
Competitive position	Very strong
Financial risk profile	Very strong
Capital and earnings	Very strong
Risk position	Intermediate
Financial flexibility	Adequate
Modifiers	+1
ERM and management	0
Enterprise risk management	Strong
Management and governance	Strong
Holistic analysis	+1
Liquidity	Strong
Support	0
Group support	0
Government support	0

IICRA--Insurance industry and country risk assessment. Note: Support does not consider ratings above sovereign criteria.

## Related Criteria

- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Insurance - General: Enterprise Risk Management, May 7, 2013
- Criteria - Insurance - General: Insurers: Rating Methodology, May 7, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria - Insurance - General: Refined Methodology And Assumptions For Analyzing Insurer Capital Adequacy Using The Risk-Based Insurance Capital Model, June 7, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

### Ratings Detail (As Of September 24, 2018)

#### Operating Companies Covered By This Report

##### HCC Insurance Holdings Inc.

Issuer Credit Rating

*Local Currency*

A-/Positive/--

##### American Contractors Indemnity Co.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

##### Avemco Insurance Co.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

Issuer Credit Rating

*Local Currency*

AA-/Positive/--

##### HCC International Insurance Co. PLC

Financial Strength Rating

*Local Currency*

AA-/Positive/--

##### HCC Life Insurance Co.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

Issuer Credit Rating

*Local Currency*

AA-/Positive/--

##### HCC Reinsurance Co. Ltd.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

##### HCC Specialty Insurance Co.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

Issuer Credit Rating

*Local Currency*

AA-/Positive/--

##### Houston Casualty Co.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

Issuer Credit Rating

*Local Currency*

AA-/Positive/--

##### United States Surety Co.

Financial Strength Rating

*Local Currency*

AA-/Positive/--

**Ratings Detail (As Of September 24, 2018) (cont.)****U.S. Specialty Insurance Co.**

Financial Strength Rating

*Local Currency*

AA-/Positive/--

Issuer Credit Rating

*Local Currency*

AA-/Positive/--

**Domicile**

Texas

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