



## The Real Difference Between Financial Stability Ratings in Insurance

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November 4, 2021

If you're familiar with financial strength ratings, you've probably heard of AM Best, an insurance-only rating agency. There's also Demotech, Fitch Ratings, and Kroll Bond Rating Agency. And don't forget S&P and Moody's, both of which rate bonds and businesses across several industries.

Getting rated by any of these is essential for a home insurance company because of the demands mortgage companies put on homebuyers. Mortgage lenders require home insurance to protect their financial investment, and they all require the home insurance company to be well rated.

So which is the right choice? Each of these firms are reputable and accurately reflect an insurance company's financial strength, so it's a matter of preference. But there are a couple key reasons we pursued a rating from Demotech instead of AM Best, which is the better known financial rating agency of the two. AM Best has been around for more than 120 years, and for most of that time, the company has had virtually no competition.

If you're like me, that lack of competition might give you pause, too.

### Older Doesn't Always Mean Better

You may have noticed that many legacy insurance companies are rated by AM Best instead of other financial strength rating firms. Between that and AM Best's age, some folks assume it must be the better rating. That's just not the case.

The reason you don't see newer companies rated by AM Best is because its ratings tend to favor incumbent carriers and subject catastrophe-prone carriers to even higher standards.

While the company's published FAQs on its rating process claims there's no minimum size or years in business required, regional insurers and new carriers are going to suffer in comparison to large, national companies that have more mature balance sheets and many more years of capital surplus contributions.

### National Financial Strength Rating Trends Have Shifted

AM Best's lack of competition and slowness to adapt to the changing needs in insurance is one of the reasons alternative rating agencies like Demotech and Kroll Bond Rating Agency have gained popularity.

For example, Demotech started rating insurers in 1985 and had its methodology reviewed and accepted by Freddie Mac and Fannie Mae by 1990. But Demotech really made its mark in 1992 when Hurricane Andrew struck.

After what was then the costliest and most destructive hurricane to ever hit Florida, many national insurers decided to exit the market. New insurance companies with investment capital came in to pick up the slack, but AM Best declined to rate them.

Demotech stepped in to help consumers figure out which of these new insurance companies had the financial stability to back up their policies. Because Florida is an \$11B home insurance market, the largest in the US and 10 percent of the total US market, it drives many national trends. What happens in Florida tends to get adopted in other areas of the country, which is most likely why Demotech is steadily gaining prominence – especially among new insurance companies.

### Insurtechs Are Increasingly Choosing Demotech

Most new insurance companies – including Lemonade, Porch's Homeowners of America, and Kin – are rated by Demotech, and that's no coincidence.

Demotech caters to new and innovative insurance companies by offering different yet similar rating processes for established P&C insurers and startups. For both, Demotech measures key financial stability ratios against its own financial stability tests and the insurer's historical operating results. Because a new carrier isn't going to have as much historical data to evaluate as a 100+ year old insurance company, Demotech focuses on a new carrier's pro forma financial statements in its business plan.

As far as we can tell, their methodology has worked so far. Demotech tests its calculations by running a series of solvent and insolvent insurance companies through its rating process. It identified nearly all the insurers that became insolvent at least one year before regulatory action.

No rating agency is perfect. We searched for instances of default and couldn't find many for companies with top ratings from either Demotech or AM Best – except for one. Despite having an A rating from AM Best, Merced Insurance became insolvent following California's 2018 Camp Fire.

### So, Which Is Better?

Again, all of the ratings agencies mentioned here are good; they just serve different audiences and purposes. Some cater to legacy companies while others align with innovators. It's a matter of preference, and you already know which I prefer.

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Henry Rodriguez CPAU, CEO

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