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Research Update:

R.V.I. Guaranty Co. Ltd. And U.S. Subsidiaries Outlook Revised To Stable; 'BBB' Ratings Affirmed

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Overview

- R.V.I. Guaranty Co. Ltd. and its U.S. subsidiaries (collectively, RVI) have reported good and stabilizing earnings over the past few years and through first-quarter 2011, despite still difficult market conditions.
- RVI successfully commuted its financial guarantee reinsurance portfolio in 2010 and no longer has exposure to this line of business.
- As a result, we are revising our outlook on these companies to stable from negative.
- We are affirming our 'BBB' counterparty credit and financial strength ratings on R.V.I. Guaranty Co. Ltd. and its affiliates.

Rating Action

On June 3, 2011, Standard & Poor's Ratings Services revised its outlook on Bermuda-based R.V.I. Guaranty Co. Ltd. and its U.S.-based subsidiaries--R.V.I. America Insurance Co. and R.V.I. National Insurance Co.--to stable from negative. At the same time, Standard & Poor's affirmed its 'BBB' counterparty credit and financial strength ratings on these three entities.

Rationale

The outlook revision reflects RVI's good and stabilizing earnings despite tough market conditions over the past few years. Revenues continue to decline, though not as much as they did in 2009, when revenues dropped by more than 50%. Based on the insurance financial statement basis of reporting--treating all of RVI's policies as insurance contracts--the company generated $35.7 million in revenue in 2010 (excluding realized capital gains on investments), compared with $39.2 million in 2009. Similarly, in first-quarter 2011, RVI reported $8.3 million in revenue relative to $9.5 million in the same period in 2010, as it has fewer product offerings. In addition, RVI successfully commuted its financial guarantee reinsurance portfolio in 2010 and no longer has exposure to this line of business. The commutation did not result in a gain or loss for RVI. On the other hand, the declining premiums earned make the operating performance metrics highly sensitive to small changes in other accounts, such as loss expenses and other operating expenses.

RVI benefits from good expertise in the residual value niche market, especially in the passenger vehicle and commercial equipment segments. Many insurance carriers have exited this segment, and RVI is now the only monoline residual value carrier left that actively markets this product. However, the prospects for this line of business remain uncertain because of the potential accounting changes.

RVI's investment strategy is conservative, focusing on the preservation of principal and the optimization of aftertax yields. As of March 31, 2011, the company's $226 million in investments were primarily invested in highly rated fixed-income securities with an average credit rating of 'AA'. The company also has good capital adequacy, which we view as a strength to the rating, compensating for RVI's concentrated risk profile.

In our opinion, the weak macroeconomic conditions over the past few years have affected RVI's franchise. Although the company has good expertise in its residual value niche market, its competitive position has markedly weakened. RVI's gross premiums written (GPW) have continued to decline, to $18.2 million in 2010 from $19.6 million in 2009, $39.0 million in 2008, and $44.2 million in 2007. Although the 7% decrease in 2010 (and the 10% decline through first-quarter 2011) was not as large as the decline between 2009 and 2008--when GPW dropped by almost 50%--the continued declining trend highlights the challenges that RVI is facing. The decrease in RVI's top line resulted mainly from the difficult market conditions and the company's decision to provide only FASB and catastrophe levels of coverage for both passenger vehicle and commercial equipment. As a result, the company's client concentration risk is now a more significant issue given its small size and lack of diversification. Therefore, the loss of any significant passenger vehicle or commercial equipment client could have a more pronounced impact on overall revenues and on RVI's competitive position.

RVI has an experienced management team that has a thorough understanding of the residual value insurance market. However, because of the size of the company and the decreasing levels of participation in the broader residual value market (and, consequently, lower premiums written), we continue to believe that RVI is exposed to key-man risk and potential disruption of operations should one (or more) of the key personnel leave the company.

The company no longer provides primary asset risk coverage in passenger vehicle, and it underwrites only lower-risk FASB and catastrophe levels of coverage in passenger vehicle, commercial equipment, and commercial real estate, which exposes it to further reductions in premium volumes from a potential change in lease accounting. Approximately 50% of RVI's premium volume is subject to the FASB standards currently in place. This remains a significant risk because certain changes could expose the company to a significant reduction in premium volume or earnings unless management is able to move toward other profitable residual value insurance markets. We expect that FASB coverage may not be viable in the next three to four years, though this estimated time frame is highly subjective because of the uncertainty surrounding the timing for completion of the FASB/IASB leases project and policyholders' reactions to potential changes in the accounting for leases once finalized.

Outlook

The stable outlook reflects the expectation that RVI's earnings will likely continue to stabilize over the next 12 to 24 months. Going forward, RVI will provide only FASB and catastrophe levels of residual value coverage for passenger vehicle, commercial equipment, and commercial real estate. This narrow business focus limits the amount of premiums the company can write and subjects its competitive position to significant uncertainty as the new FASB accounting rules are finalized. RVI's recent reentry into the real estate market will not have an immediate impact because the company will need to rebuild its book of business over time.

Based on RVI's focus on FASB and catastrophe coverage, we expect the company to report moderate but declining earnings in 2011 under its insurance basis financial statements. We expect the company to report net income of $13 million to $15 million and a combined ratio of 60%-65% on an insurance financial statement basis. The benefits of reentering the commercial real estate business will take time to affect earnings. In addition, the risk of earnings volatility will remain because the company is less diversified, has a high client concentration, and has a decreasing premium base with which to generate earnings. Further, macroeconomic conditions remain a risk to the values of the type of assets that RVI insures.

We are unlikely to raise the ratings over the next 12 months given RVI's business and financial profiles. Alternatively, if the company cannot sustain its already constrained competitive position and suffers losses, which would diminish its capital position, we could lower the ratings.

Related Criteria And Research

- Evaluating Insurers' Competitive Positions, April 22, 2009
- Analysis Of Nonlife Insurance Operating Performance, April 22, 2009

Ratings List

Ratings Affirmed; Outlook Action

	To	From
R.V.I. Guaranty Co. Ltd.		
R.V.I. National Insurance Company		
R.V.I. America Insurance Co.		
Counterparty Credit Rating	BBB/Stable/--	BBB/Negative/--
Financial Strength Rating	BBB/Stable/--	BBB/Negative/--

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