AM Best's Criteria Updates & Initiatives

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Send questions to:

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Agenda

- Intros
- ESG Developments and their Impact on Insurer Ratings
- AM Best’s PA for DUAEs
- IFRS17 and Cyber
- Q&A

ESG Developments and their Impact on Insurer Ratings

ESG Concepts

UN FI Principles of Sustainable Insurance

ESG Impact on Credit Quality

ESG within AM Best's Methodology

Understanding ESG Concepts

The consideration of environmental, social and governance factors alongside financial factors in the investment and underwriting decision-making processes

Environmental factors relate to resource use, pollution, climate risk, energy use, waste management, and other physical environmental challenges and opportunities

Social factors relate to how a company interacts with the communities it operates in, its suppliers, employees, and broader stakeholders

Governance factors relate to procedures and processes according to which a company is directed and controlled

What Are ESG Factors?

Examples of ESG factors

- Climate risks
- Carbon emissions
- Natural resources
- Pollution and waste
- Environmental opportunities

Environmental

- Human capital
- Product liability
- Stakeholder opposition
- Health and safety
- Social opportunities

Social

- Corporate governance
- Corporate behaviour
- Transparency
- Board composition
- Business ethics

Governance

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UNEP FI Principles for Sustainable Insurance (PSI)

- The United Nations Environment Programme Finance Initiative (UNEP FI) is a global partnership established between the United Nations Environment Program (UNEP) and the financial sector. It was created in 1992, following the Earth Summit in Rio de Janeiro.
- Endorsed by the U.N. Secretary-General, the Principles for Sustainable Insurance have led to the largest collaborative initiative between the U.N. and the insurance industry. Over 140 organizations worldwide have adopted the four Principles for Sustainable Insurance, including insurers representing more than 25% of world insurance premium volume and USD 14 trillion in assets under management. The Principles are part of the insurance industry criteria of the Dow Jones Sustainability Indices and FTSE4Good.
- The Principles serve as a global framework for the insurance industry to address ESG risks and opportunities.

AM Best is a UNEP FI[1] PSI Signatory

In March 2021, AM Best became the first credit rating agency to become a signatory of the **Principles for Sustainable Insurance**

Principle 1	Principle 2	Principle 3	Principle 4
We will embed in our decision-making environmental, social and governance issues relevant to our insurance business.	We will work together with our clients and business partners to raise awareness of environmental, social and governance issues, manage risk and develop solutions.	We will work together with governments, regulators and other key stakeholders to promote widespread action across society on environmental, social and governance issues.	We will demonstrate accountability and transparency in regularly disclosing publicly our progress in implementing the Principles.

[1]United Nations Environment Programme Finance Initiative

What Becoming a UNEP FI PSI Signatory Means for AM Best

- AM Best has publicly committed to supporting the PSI Principles and the sustainability of the insurance industry.
- Being a PSI Signatory fits AM Best's focus on insurance and our perspective that ESG elements play an important role in the financial strength of insurance companies.
- AM Best will prepare its PSI-required annual Public Disclosure, in which we will showcase all of AMB's efforts/activities in support of the Principles and a financially strong insurance industry.

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ESG Impact on Credit Quality

ESG is relevant when it has a visible impact on financial strength. Positive ESG attributes may have no impact on a rating.

ESG while important is not a new concept

Environmental and Governance factors have long been part of the credit analysis and captured in our rating opinions

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- Many ESG factors have long been part of AM Best's Credit Rating Methodology. ESG factors were fully integrated into BCRM in 2018 to increase transparency.

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
• Climate risk • ESG integration in investing activities • Stranded assets	• Social inflation • ESG-related litigation • Impact of ESG integration on profitability	• Underwriting exclusions • Changing demographics • Data privacy • Reputational risk	• Corporate governance • Stress testing • Financial and non-financial risks

- ESG factors, where material and relevant, may impact any one, or several building blocks
- Impact of ESG is viewed purely from an analytical perspective: focusing on the impact on the credit rating
- No judgement is made on the ethical value of ESG activities

AM Best and ESG – Resources

- ESG webpage: http://www.ambest.com/about/esg.html

ESG Webinar

Environmental, Social & Governance (ESG) Factors

"ESG" (environmental, social and governance) has gained significant traction in recent years to improve transparency of risks not captured by standard financial metrics so that informed choices can be made by stakeholders. Understanding and integrating ESG principles into strategy is becoming increasingly important for insurers. Whilst there has been strong consideration for ethical and moral values, aspects such as sustainability and management of climate-related risks are prominent for the insurance industry. Insurers' play a unique role within ESG as risk carriers, asset managers and institutional investors.

With no industry-wide ESG standards in place, it can be overwhelming for market players to fully understand how to implement and disclose ESG practices. Despite this, several factors usually considered ESG-related described below, are evaluated to determine their materiality in respect to a particular building block.

For climate-related risk there are three main areas of focus for the insurance market: physical, transition and liability related risks. Physical risk captures the changing frequency and intensity of weather-related events, transitional risk is associated with transition to a low-carbon economy and liability risk relate to possible increases in litigation arising from say, pollution or contamination. All these factors can impact the creditworthiness of an insurer and affect the financial strength,

ESG within Best's Credit Rating Methodology

AM Best's Performance Assessment (PA) for Delegated Underwriting Authority Enterprises (DUAEs)

What is a Performance Assessment (PA)?

A measurement of the relative ability of an enterprise to perform services on behalf of insurance partners

Key components are assessed and assigned points based on the entity's performance

The summation of the points from each key component determines the Assessment Range which translates into the Performance Assessment

What is a Delegated Underwriting Authority Enterprise (DUAE)?

- AM Best defines a DUAE as a third party entity that is appointed by a (re)insurer, through contractual agreements, to perform underwriting, claims handling, and/or administrative functions on behalf of their carrier partners
- Typically carried out by insurers, DUAE's functions can include:

Binding coverage	**Underwriting and pricing**	**Settling claims**	**Appointing retail agents in a certain region**	**Access to niche segments and markets**

- The DUAE manages all or part of the insurance business of an insurer and acts as an insurance agent or broker for the insurer, while working as the intermediary between insurers and agents, and/or insured

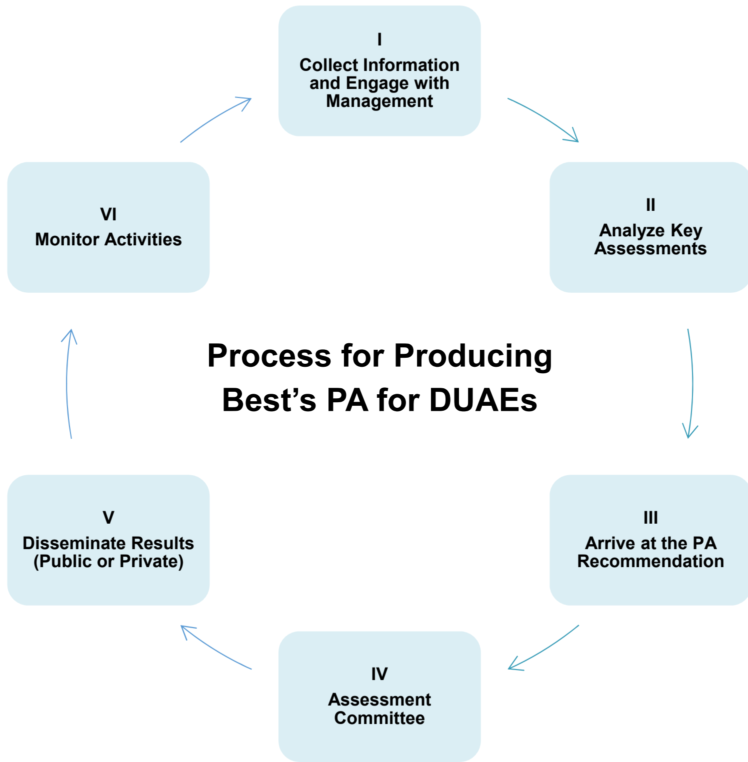
Growing Importance of DUAEs

- Increasingly important part of the insurance value chain (insurance distribution model)
- Main presence in US, UK and Australia; gaining traction in other markets
- Actively used by global insurance players, in addition to small specialized insurers
- Provide a variety benefits:

Distribution	**Underwriting expertise**	**Claims management**	**Access to niche segments and markets**

Best's Performance Assessment (PA) for Delegated Underwriting Authority Enterprises (DUAEs)

- Interactive process entails gathering information, engaging with clients (through a formal management meeting), assessing key factors, followed by an assessment committee, and public dissemination (if client agrees), and finally a Performance Assessment Report.
- There are outlooks associated (Positive, Stable, and Negative) with the assessment. The DUAE can be placed under review.
- There is no termination period, with ongoing surveillance of the DUAE.
- Any withdrawal of a PA from the process will need a final assessment.



PA for DUAEs Components

Key Assessment Factor	Max Points
Underwriting Capabilities	10 (steps of 2)
Governance and Internal Controls	10 (steps of 2)
Financial Condition	10 (steps of 2)
Organizational Talent	5
Depth and Breadth of Relationship	5

A higher overall number of points indicates the DUAE's relative ability to perform services on behalf of its insurance partners through:

- effective business underwriting
- strong financial condition
- excellent access to business
- high-level service
- strong business relationships and governance

Best's PA for DUAEs = Underwriting Capabilities + Governance and Internal Controls + Financial Condition + Organizational Talent + Depth and Breadth of Relationships

* Underwriting Capabilities, Governance & Internal Controls and Financial Condition have twice the weight of other components

PA for DUAEs – Final Outcome

Assessment Categories	Assessment Symbols	Assessment Ranges
Exceptional	PA-1	34-40
Excellent	PA-2	27-33
Strong	PA-3	20-26
Fair	PA-4	13-19
Weak	PA-5	Up to 12

The PA scale outlines the DUAE's:

- Relative ability to perform services on behalf of its insurance partners
- Underwriting expertise
- Financial performance indicators
- Company processes
- Appropriateness of governance and internal controls

PA for DUAEs – Current State

- Draft Methodology was published in early March
- Comment Period ended on May 3, 2021
  - Reviewing Comments now
  - Review feedback from industry outreach
- Industry outreach and education is ongoing
- Beta tests are underway
- Impact of beta testing will influence official rollout

IFRS17 and Cyber

IFRS17 – Recap

- IFRS 17 is an International Financial Reporting Standard (IFRS) issued by the International Accounting Standards Board (IASB) in May 2017, amended in June 2020 for initial implementation in January 2023.
- It replaces insurance liability accounting for IFRS reporters - long thought unsatisfactory as:
  - Inconsistent between territories (grandfathers previous territory specific GAAPs)
  - Inconsistent within companies (different GAAPs consolidated within same insurer)
  - Life accounting often reflects its prudential management origins, which then has been "patched-up" to use for external financial reporting
  - Widely varying, and frequently distant, relationships to value
  - High profile of supplementary reporting (value based, regulatory), which is obscure to non-specialists
  - Opaque to many users, problematic public face of industry in financial markets

IFRS – What it Does

Market values both sides of balance sheet

- Principles based
- Reliance on auditors
- Insurance liability - discounted best estimate, plus risk adjustment (RA)
- Applies to global operations. No parallel to ‘equivalence’ under SII

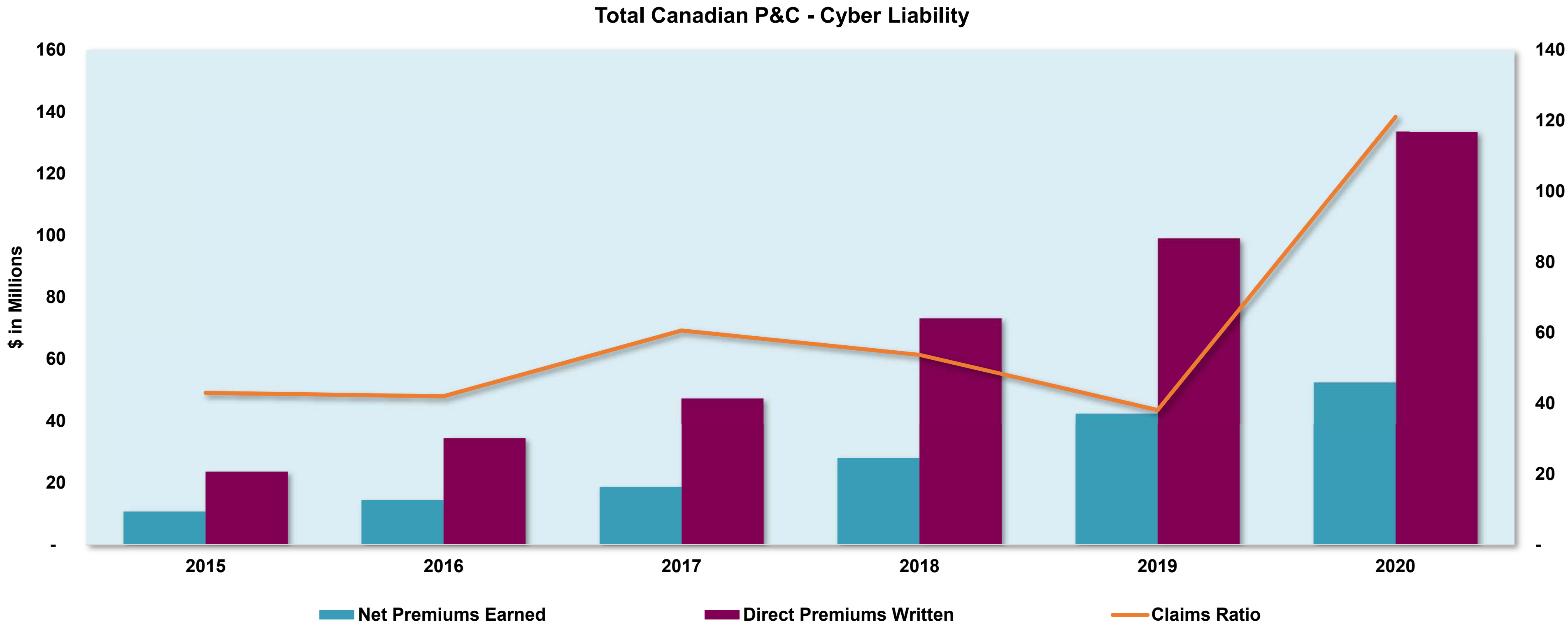
No day-one profit

- For long-term contracts (life), day one profit goes to Contractual Service Margin (CSM, a liability) – “GMM”
- CSM fed into profit over term of contract
- Profit on remaining coverage not identified for 12 month/non-life contracts – “PAA”
- Experience variances set against relevant year’s CSM
- ‘Onerous contracts’ losses go straight to P&L

Differences from embedded value

- ‘Dual look’, day one estimated profit is identified but not taken
- Delivery of new business profit is tracked
- Audited ‘from the ground up’. No reference to regulatory data

Cyber Liability Market in Canada



Source: Office of the Superintendent of Financial Institutions (OSFI)