



## A.M. BEST COMPANY, INC.

### Form NRSRO: Exhibit 2

# General Description of the Policies and Procedures Used to Determine Credit Ratings

## Initiation of Credit Ratings and Unsolicited Ratings:

A.M. Best Company's primary rating services business is the issuance of insurer financial strength ratings. The company also issues ratings to parent holding companies, bank deposit ratings, and debt ratings on securities issued by these organizations and certain insurance-linked transactions.

Rating relationships are typically initiated when an unrated organization/issuer requests a rating from A.M. Best. Generally, A.M. Best enters into a rating services agreement with the entity whereby obligations of the entity and A.M. Best are enumerated, and the rating fee(s) established.

In certain circumstances, Best may assign a "Public Data" ("pd") rating (unsolicited rating), which is an assessment as to the creditworthiness of an organization that is arrived at without the full participation of the rated entity. All "pd" ratings are identified with pd immediately following the rating. We will only assign a "pd" rating in instances where we believe we have sufficient information to determine an opinion. A.M. Best does not assign "pd" ratings to debt or debt-like instruments nor do we seek payment for the issuance of "pd" ratings.

## Information Sources:

Information relied on in the rating process typically includes official annual and quarterly (if available) financial statements as filed with the regulator of the state, province or country in which the company is domiciled and supplemented by other publicly available documents, such as Securities and Exchange Commission (SEC) filings in the United States, or International Accounting Standards (IAS) financial statements.

Other sources of information may include business plans provided by companies/issuers, audit reports prepared by certified public accountants or other information provided by third party vendors, the issuer, or agents of the issuer such as its legal counsel or other experts that are considered reliable and other publicly available information regarding the rated entity. A.M. Best expects all information submitted by rated entities or their agents and third party vendors to be accurate and complete. This includes information requested by A.M. Best as well as information that has not been publicly disclosed or specifically requested. A.M. Best further expects that any information relevant to the rating process will be submitted on a timely basis, including any relevant changes in the rated entity's/issue's financial condition.

A.M. Best does not perform, nor is it obligated to perform, independent verification of information used in the rating process, does not perform audits or inspections, and as noted above, may rely on issuers and/or its agents for the accuracy, completeness and timeliness of information. As such, the assignment of Best's Credit Ratings should not be viewed as providing any type of assurance as to the accuracy, completeness or timeliness of information used in its communications, publications or the rating opinion itself.

## Interaction with Management of a Rated Obligor or Issuer of Rated Securities:

Meetings with the management teams of rated entities/issuers are an integral part of A.M. Best's interactive rating process. Typically, two A.M. Best analysts, the primary analyst and team leader, meet with management on an annual basis. These face-to-face meetings are generally supplemented with additional interaction between A.M. Best analysts and management throughout the year, on an as needed basis. As previously noted, business plans provided by rated entities/issuers are an extremely valuable source of information in the rating process. Management typically provides detailed business plans, which may include non public information, regarding the firm's strategic and financial planning and reviews of financial performance. In addition to providing our analysts additional insight related to the underlying quantitative operating fundamentals of an obligor/issuer, these meetings also provide our analysts the opportunity to better develop a qualitative assessment of management, which is an important component of our overall rating process.

## Structure and Voting Process of Rating Committees:

Ratings analysts and rating committees are required to meet the standards and requirements of and conduct themselves in accordance with the criteria set forth in the company's Credit Rating Review and Assignment Policy and the A.M. Best Code of Conduct, among other policies and procedures.





Once sufficient information has been gathered and analyzed in accordance with the relevant methodologies for the type of rating to be assigned, the primary analyst and team leader present the credit rating recommendation to a rating committee.

The assignment of credit ratings by a rating committee, and not by any specific analyst, is essential in promoting and maintaining the integrity, consistency and fairness of the rating process. The rating committee is primarily comprised of senior analysts that have appropriate knowledge concerning the type of rating to be determined.

## **Procedures for Informing Rated Obligors or Issuers of Rated Securities of Credit Rating Decisions and for Appeals of Rating Decisions:**

Following a committee's rating decision, obligors/issuers, or their authorized representatives, are contacted by A.M. Best analysts as soon as practical thereafter and informed of the committee's rating decision and the critical information and considerations upon which the committee based its decision. Where feasible, and in accordance with A.M. Best's Rating Monitoring and Dissemination Policy, A.M. Best may forward a draft copy of a press release announcing its rating decision to allow the obligor/issuer the opportunity review the information. While the obligor/issuer is in possession of such confidential information, A.M. Best expects the obligor/issuer to treat it as such. Should A.M. Best believe that the information has been misused in any way or has become known to outsiders for any reason, A.M. Best reserves the right to make public its rating decision immediately. A.M. Best forwards such information to the obligor/issuer to allow it the opportunity to ensure that no confidential information is contained therein, however, as a publisher; A.M. Best retains absolute control over its ratings, the timing of the release of its ratings, and its independent commentary regarding its opinions.

For smaller non-public insurers that do not have rated debt securities outstanding, A.M. Best may inform the company by letter. The letter includes the critical information and considerations upon which the rating committee based its decision.

Where feasible and appropriate, rated obligor's/issuer's are afforded a brief period to appeal a rating decision, at which time they are required to provide clarification regarding the principal considerations on which the rating is based, or new information, that could reasonably be expected to influence a rating committee decision. In rare instances in which A.M. Best believes it may take a considerable amount of time to resolve an appeal, the rating may be placed "Under Review."

## **Procedures for monitoring, reviewing and updating credit ratings**

Following the assignment of a rating, A.M. Best monitors its credit opinion on a regular and as needed basis. Generally, a credit opinion is formally reviewed at least annually. In addition to the annual credit review process, A.M. Best analysts monitor industry conditions and/or obligor/issuer specific events that could be expected to have an impact on an obligor's/issue's creditworthiness on an interim basis. A.M. Best may modify or affirm ratings following these reviews.

A.M. Best disseminates credit rating actions as soon as practicable following informing the obligor/issuer of its rating decision, on a non-selective basis, and free of charge on our publicly accessible web site. Ratings may also be released simultaneously through press releases and in electronic subscription services. Ratings actions will subsequently appear in other A.M. Best printed publications.

## **Procedures to Withdrawal a Rating:**

As a publisher, A.M. Best reserves the right to withdrawal a rating at any time. For example, A.M. Best reserves the right to suspend or withdrawal a rating if it believes that the information provided to us is inadequate to continue rating an obligor/issuer/issue. The withdrawal of a rating is subject to the rating committee process as outlined in the Rating Review and Assignment Policy. In instances where A.M. Best suspends or withdrawals a rating, we issue a press release that includes an explanation as to why the rating was suspended or withdrawn. A rating committee or press release is not required in instances where a debt or debt-like instrument matures and is no longer outstanding.

*For more information on the polices and procedures regarding the initiation of ratings and unsolicited ratings, rating committees, and monitoring, reviewing and updating credit ratings, please visit <http://www.ambest.com/nrsro/index.html>*

## **Rating Methodologies:**

Following are general descriptions of the methodologies/criteria used in determining ratings for the categories that A.M. Best is currently registered as a nationally recognized statistical rating organization. In any given rating action, a rating committee will determine what specific aspects of the overall methodology/criteria that are relevant to that particular action. More detailed information



on rating methodologies/criteria for the types of ratings issued by A.M. Best are available on our public web site at <http://www.ambest.com/ratings/methodology.asp>

### **Insurance Companies**

A.M. Best Company's primary rating services business is the issuance of insurer financial strength ratings. The primary objective of Best's Credit Ratings within the insurance segment is to provide an opinion as to the rated entity's ability to meet its senior financial obligations, which for an operating insurance company are its ongoing insurance policy and contract obligations. The assignment of an interactive rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance and business profile, as compared with A.M. Best's quantitative and qualitative standards.

In determining a company's ability to meet its current and ongoing obligations, the most important area to evaluate is its balance sheet strength, since it is the foundation for financial security. Balance sheet strength measures the exposure of a company's equity or surplus to volatility based on its operating and financial practices. One of the primary tools used in the evaluation of balance sheet strength for an insurer is Best's Capital Adequacy Ratio (BCAR), which provides a quantitative measure of the risks inherent in a company's investment and insurance profile, relative to its adjusted capital. A.M. Best's analysis of the balance sheet also encompasses a thorough review of various financial tests and ratios, typically over a five-year period. The same models are used for initial ratings and for the ongoing monitoring of ratings. Significant changes made to the models and criteria changes are applied to existing ratings.

The assessment of balance sheet strength includes an analysis of an organization's regulatory filings, including the GAAP or IFRS balance sheet, at both the operating insurance company and consolidated level. To understand the strength and flexibility of an insurer's balance sheet, a variety of tests and measures are reviewed which include an assessment of the corporate capital structure, financial leverage, fixed charge coverage, liquidity, and historical sources and uses of capital.

While balance sheet strength is the foundation of the rating process, the balance sheet provides only an assessment of capital adequacy at a point in time. A.M. Best views operating performance and business profile as leading indicators when measuring future balance sheet strength and financial security.

The term "future" is the key, since ratings are prospective and go well beyond a "static" balance sheet view. Profitability is the engine that ultimately drives capital, and looking out into the future enables the analyst to gauge a company's ability to preserve and/or generate new capital over time. In many respects, what determines the relative strength or weakness of a company's operating performance is a combination of its business profile and the ability of a company to effectively execute its strategy.

A strongly performing company, over time, will generate earnings sufficient to maintain a prudent level of risk-adjusted capital and optimize stakeholder value. Strong performers are those companies whose earnings are relatively consistent and deemed to be sustainable. Because of their track record and better-than-average earnings power, these companies typically benefit from higher ratings and/or lower capital requirements relative to their peers.

On the other hand, companies that have demonstrated weaknesses in their earnings through either consistent losses or volatility are more likely to struggle to maintain or improve capital in the future. For these reasons, these companies typically are rated lower than their counterparts that perform well and/or usually are held to higher than minimum capital requirements to minimize the chance of being downgraded if current trends continue.

A.M. Best believes that risk management is the common thread that links balance sheet strength, operating performance and business profile. Risk management fundamentals can be found in the strategic decision-making process used by a company to define its business profile, and in the various financial management practices and operating elements of an insurer that dictate the sustainability of its operating performance and, ultimately, its exposure to capital volatility. As such, if a company is practicing sound risk management and executing its strategy effectively, it will preserve and build its balance sheet strength and perform successfully over the long term – common objectives of both A.M. Best ratings and risk management.

### **Corporate Issuers**

Insurance holding company structures provide a means to facilitate public ownership of insurers, which are regulated entities, and also provide greater flexibility in accessing the capital markets. A.M. Best assigns Issuer Credit Ratings to these holding companies. The financial strength rating of the operating insurers is an integral component of the assessment of the parent holding company's ability to repay its financial obligations and is fundamentally an extension of the review of the operating companies taking into consideration the risks inherent in the holding company's operations. Since a holding company's operations are generally limited in nature and primarily exist to fund the operations of subsidiaries, a variety of tests and measures are reviewed, which include an assessment of the corporate



capital structure, financial leverage, fixed charge coverage, liquidity, and historical sources and uses of capital.

### **Issuers of Asset-Backed Securities**

To date, all of the company's ratings in this category represent collateralized obligations of insurance organizations. The collateral overwhelmingly consists of trust preferred securities, surplus notes, or annuities – all of which are direct obligations of insurers. The Insurance-Linked Securities group relies on the insurer financial strength ratings issued by A.M. Best for modeling transactions collateralized by such insurance obligations. In limited instances, A.M. Best may use ratings issued by certain other nationally recognized statistical rating organizations (NRSROs) for obligors not rated by A.M. Best in its modeling of specific transactions. A.M. Best uses the ratings as issued by other NRSROs without modification. Given the ratings assigned to the insurance obligors in these asset-backed pools, A.M. Best applies the credit risk derived through its impairment database in order to simulate the cash flows in the transactions and to determine the default probabilities of the rated securities. The Insurance-Linked Securities Group uses the same models for initial ratings and for the surveillance of transactions. Significant changes made to the model and criteria changes are applied to existing ratings.

### **Financial Institutions**

The primary objective of Best's Credit Ratings within the banking segment is to provide an opinion as to the rated entity's ability to meet its senior financial obligations, which for an operating bank are its bank deposits. The assignment of an interactive rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance and business profile, as compared with A.M. Best's quantitative and qualitative standards.

In determining a company's ability to meet its current and ongoing obligations, the first important area to evaluate is its balance sheet strength, since it is the foundation for financial security. The assessment of balance sheet strength includes an analysis of an organization's regulatory filings, including the GAAP or IFRS balance sheet, at both the operating bank and consolidated level. To understand the strength and flexibility of a bank's balance sheet, a variety of tests and measures are reviewed, which include an assessment of the bank's capital structure, leverage, liquidity, asset quality, asset mix, loan loss reserve adequacy and historical sources and uses of capital, as well as affiliated entities' balance sheet profiles.

While balance sheet strength is the foundation of the rating process, the balance sheet provides only an assessment at a point in time. A.M. Best views operating performance and business profile as leading indicators when measuring future balance sheet strength and financial security.

The term "future" is the key, since ratings are prospective and go well beyond a "static" balance sheet view. Profitability is the engine that ultimately drives capital, and looking out into the future enables the analyst to gauge a company's ability to preserve and/or generate new capital over time. In many respects, what determines the relative strength or weakness of a company's operating performance is a combination of its business profile and the ability of a company to effectively execute its strategy.

A strongly performing company, over time, will generate earnings sufficient to maintain a prudent level of risk-adjusted capital and optimize stakeholder value. Strong performers are those companies whose earnings are relatively consistent and deemed to be sustainable. Because of their track record and better-than-average earnings power, these companies typically benefit from higher ratings and/or lower capital requirements relative to their peers.

On the other hand, companies that have demonstrated weaknesses in their earnings through either consistent losses or volatility are more likely to struggle to maintain or improve capital in the future. For these reasons, unless abundantly capitalized well above regulatory required minimum levels and consisting of high core equity components, these companies typically are rated lower than their counterparts that perform well to minimize the chance of being downgraded if current trends continue.

Significant changes made to the model and criteria changes are applied to existing ratings.

A.M. Best believes that risk management is the common thread that links balance sheet strength, operating performance and business profile. Risk management fundamentals can be found in the strategic decision-making process used by a company to define its business profile, and in the various financial management practices and operating elements of a bank that dictate the sustainability of its operating performance and, ultimately, its exposure to capital volatility. As such, if a company is practicing sound risk management and executing its strategy effectively, it will preserve and build its balance sheet strength and perform successfully over the long term – common objectives of both A.M. Best ratings and risk management.