

Best's Credit Rating Methodology Update Briefing

Greg Carter
Managing Director, Analytics

March 2016
A.M. Best



Disclaimer



© AM Best Company, Inc. (AMB) and/or its licensors and affiliates. All rights reserved. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT AMB'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by AMB from sources believed by it to be accurate and reliable. AMB does not audit or otherwise independently verify the accuracy or reliability of information received or otherwise used and therefore all information contained herein is provided "AS IS" without warranty of any kind. Under no circumstances shall AMB have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of AMB or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if AMB is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings, financial reporting analysis, projections, and other observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. Credit ratings do not address any other risk, including but not limited to, liquidity risk, market value risk or price volatility of rated securities. AMB is not an investment advisor and does not offer consulting or advisory services, nor does the company or its rating analysts offer any form of structuring or financial advice. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY AMB IN ANY FORM OR MANNER WHATSOEVER. Each credit rating or other opinion must be weighed solely as one factor in any investment or purchasing decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security or other financial obligation and of each issuer and guarantor of, and each provider of credit support for, each security or other financial obligation that it may consider purchasing, holding or selling.

Disclaimer (2)



US Securities Laws explicitly prohibit the issuance or maintenance of a credit rating where a person involved in the sales or marketing of a product or service of the CRA also participates in determining or monitoring the credit rating, or developing or approving procedures or methodologies used for determining the credit rating.

No part of this presentation amounts to sales / marketing activity and A.M. Best's Rating Division employees are prohibited from participating in commercial discussions.

Any queries of a commercial nature should be directed to A.M. Best's Market Development function.

Rating Methodology 2017



- Impetus for Change
- Timeline
- Building Block Approach
- Rating Implications
- Questions

Impetus for Change



- Transparency & consistency
- A move towards best practices
- A way to integrate new tools
 - Application of BCAR

Tentative Timeline



03/10/16

Draft BCRM & PC BCAR criteria is released for comment

Comment period will include public updates as specific issues raised

Comment period will be extended to coincide with release of all BCAR models

12/31/16

Comment period ends

Comments incorporated as necessary into BCRM and all BCAR criteria

BCRM and BCAR criteria is published and becomes effective

Remainder of 2016

1Q 2017

An Updated BCRM



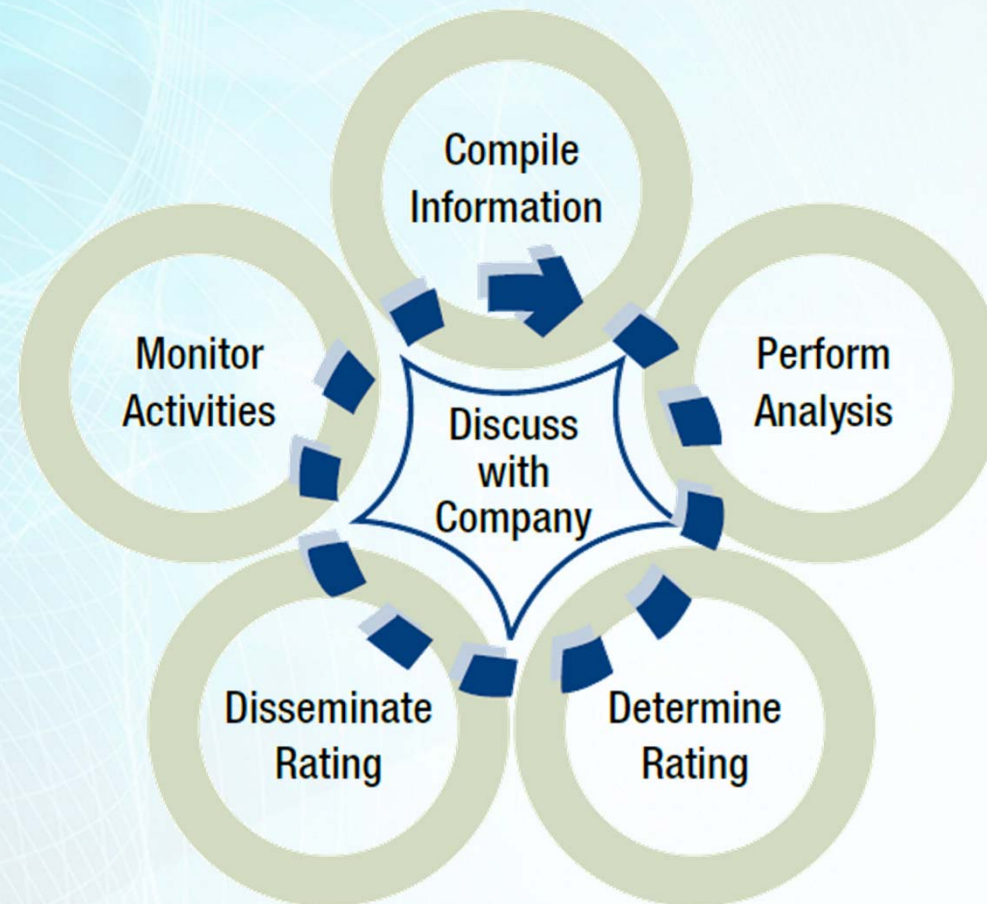
The BCRM will be the key source document for deriving ratings

- Issuer Credit Ratings
- Financial Strength Ratings
- Issue Ratings

An Updated BCRM



Not a fundamental change to rating analysis



An Updated BCRM



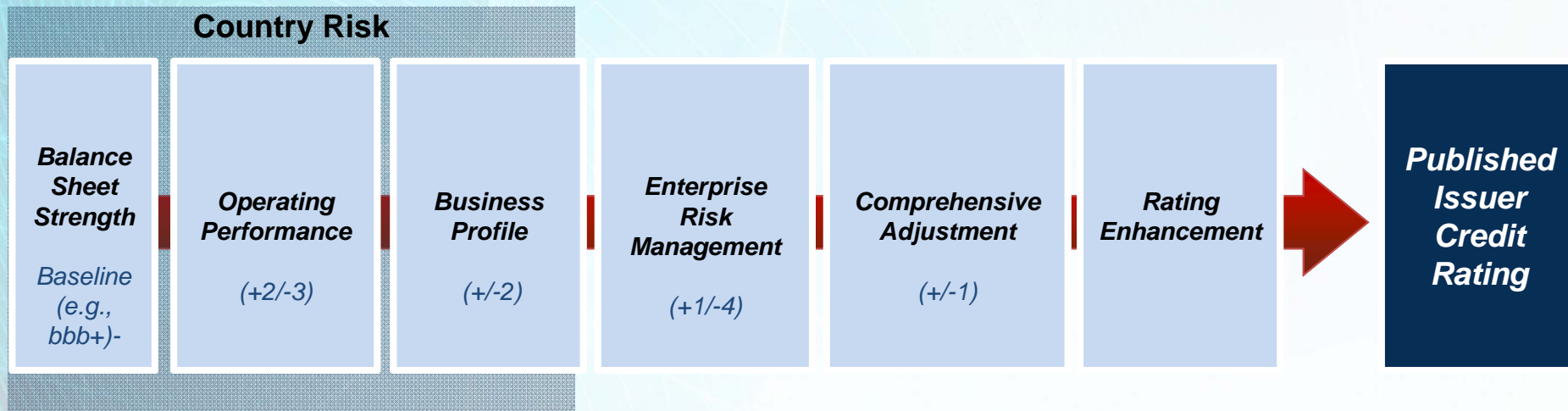
The BCRM is being updated but the fundamental rating drivers will remain the same

- Balance sheet strength
- Operating performance
- Business profile
- Enterprise risk management

The Building Block Approach



A.M. Best's Rating Process

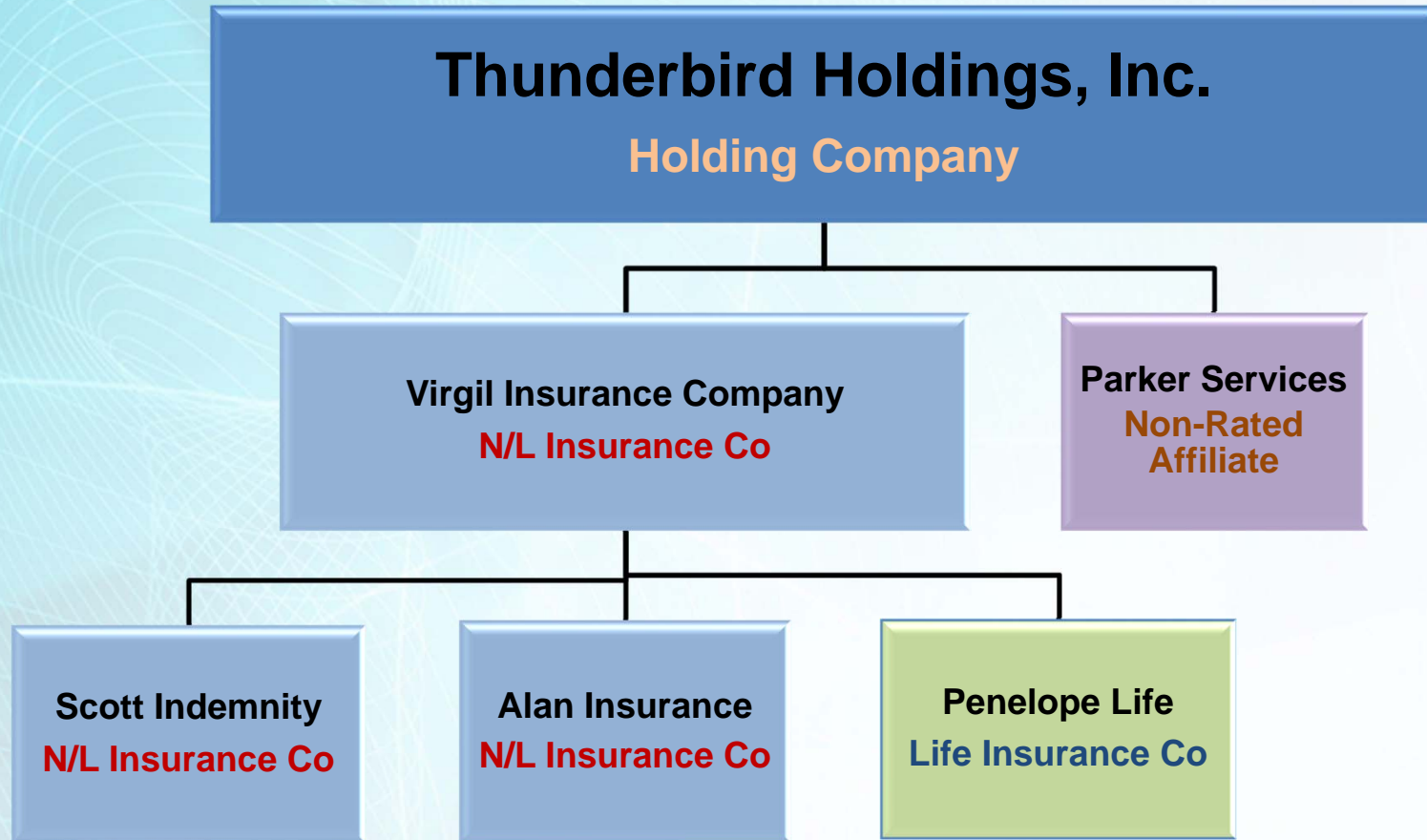


Rating Units

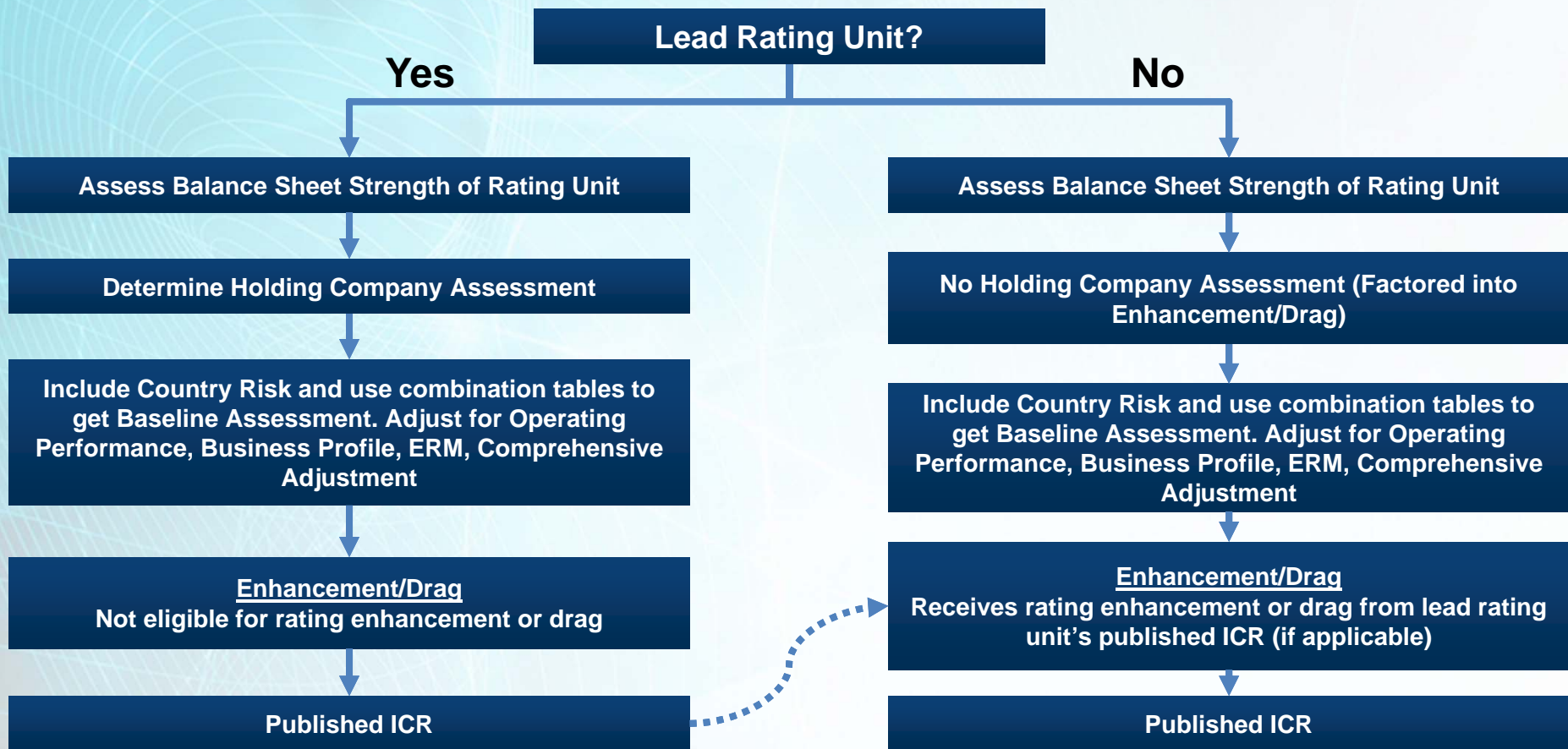


- Analysis is performed at rating unit level
 - Single legal entity OR
 - Several entities that collectively operate
- A lead rating unit is identified for organizations with multiple rating units within enterprise
 - Largest or most strategically important
- Holding company will only impact B/S assessment of the lead rating unit
- Through lead rating unit analysis, the highest possible rating from lift is determined for the group
- Additional non-lead rating units will be eligible to receive rating enhancement or drag from the lead rating unit

Organisational Structure



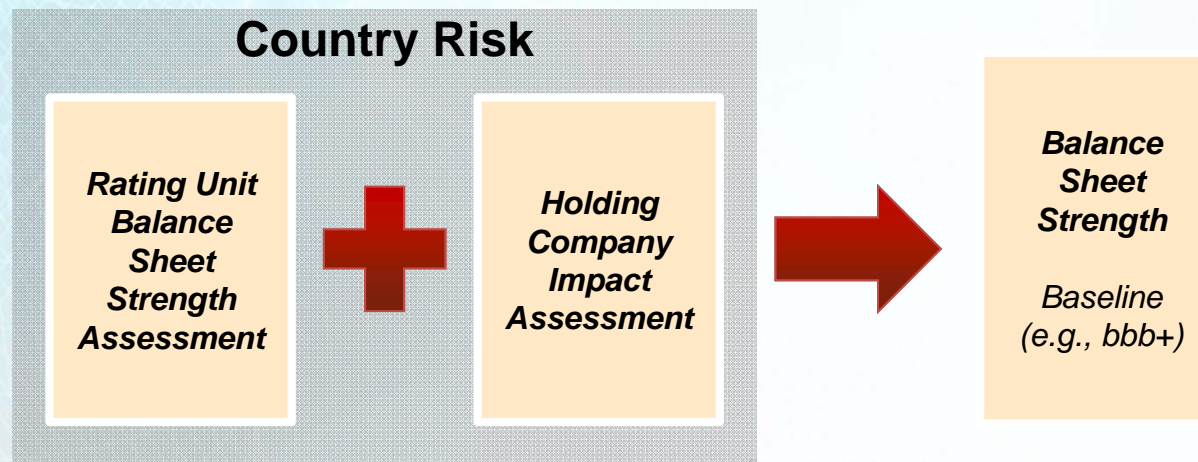
Rating Units



Balance Sheet Strength



- **Balance sheet strength** is now broken down into several parts
 - Rating unit balance sheet strength assessment
 - BCAR
 - Other qualitative and quantitative factors
 - Holding company impact assessment
 - Country risk impact



Summary of Changes to BCAR



- New Calculation of BCAR
 - Formula change
 - Difference between Available Capital and Required Capital, as a ratio to Available Capital
 - Better alignment with risk appetite/tolerance statements
- 5 scores calculated and published – instead of 1
 - 95%, 99%, 99.5%, 99.8%, and 99.9% confidence levels

Application of BCAR



- Key for rating unit evaluation
- BCAR can be run at the rating unit and the holding company levels
- Confidence level results tie into initial balance sheet assessment

Confidence Level (%)	BCAR	Implied Balance Sheet Strength
99.9	> 0 at 99.9	Strongest
99.8	> 0 at 99.8 & ≤ 0 at 99.9	Very Strong
99.5	> 0 at 99.5 & ≤ 0 at 99.8	Strong
99	> 0 at 99 & ≤ 0 at 99.5	Adequate
95	> 0 at 95 & ≤ 0 at 99	Weak
95	≤ 0 at 95	Very Weak



The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Example BCAR Scores




- The analyst will consider
 - Confidence level at which the drop-off occurs
 - Degree of the downward slope
 - Drivers of the downward slope
 - Volatility
 - Size of the drop-off

Company A's BCAR Scores					
Year	VaR 95	VaR 99	VaR 99.5	VaR 99.8	VaR 99.9
2014	64	20	0.2	-47	-208
2015	72	24	2	-45	-175

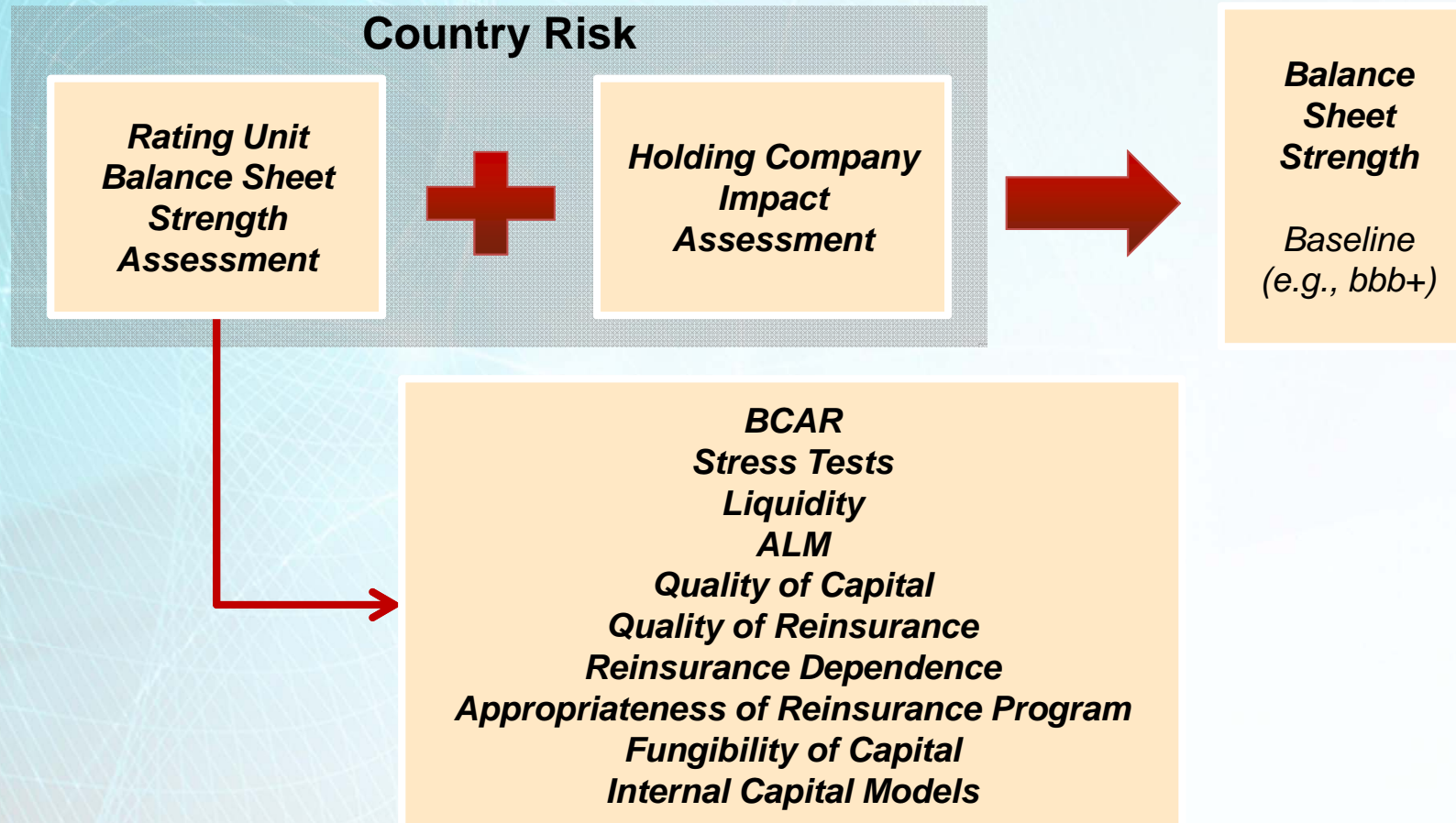
BCAR Impact on Balance Sheet View



- Scores at confidence levels provide differentiation in initial assessment categories (prior to quality of capital/holding company adjustment)

Initial Balance Sheet Strength Assessment (Rating Unit/BCAR)	
Strongest	a+/a
Very Strong	a/a-
 Strong	a-/bbb+
Adequate	bbb+/bbb/bbb-
Weak	bb+/bb/bb-
Very Weak	b+ and below

Additional Balance Sheet Factors



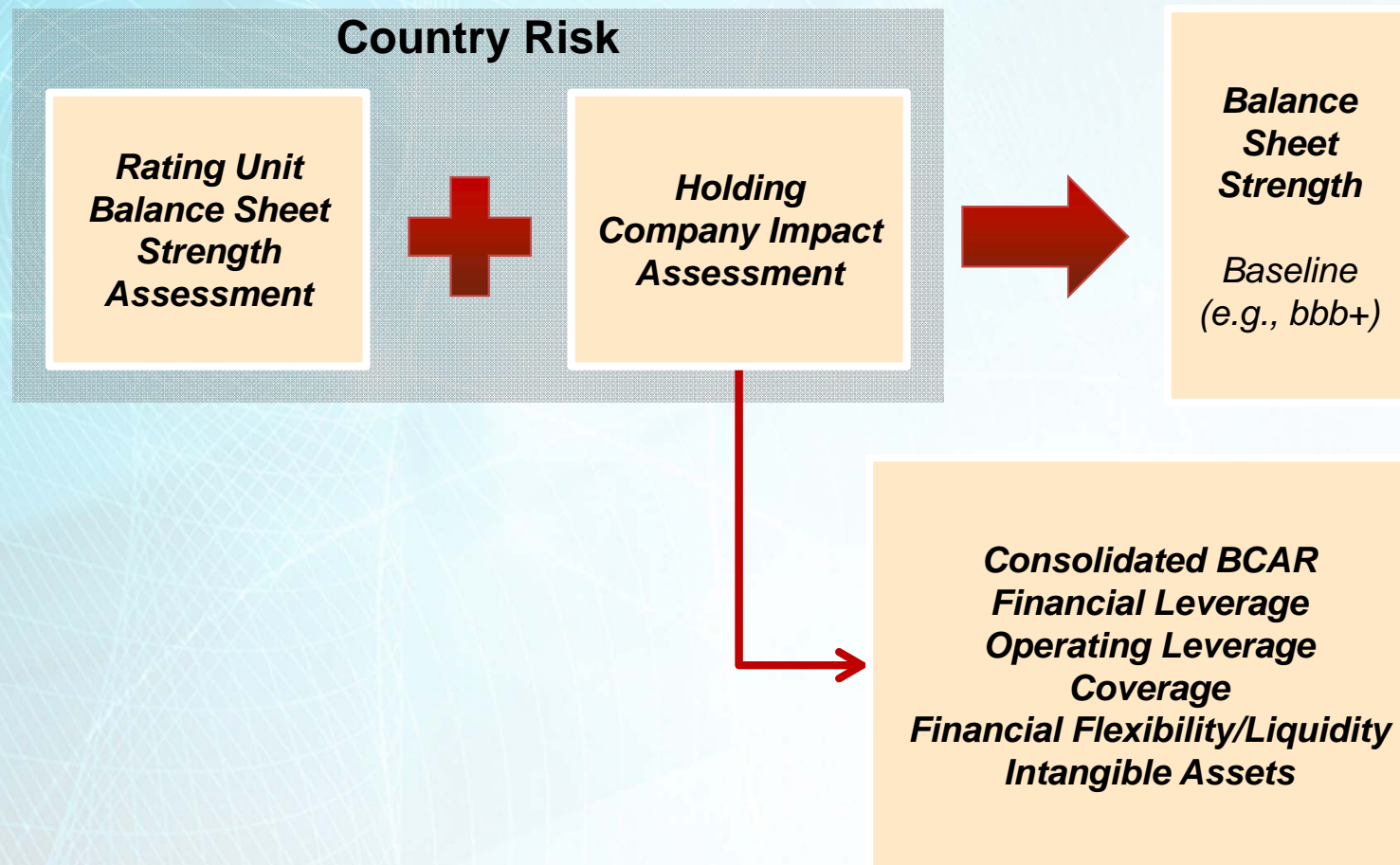
Balance Sheet Strength Assessment



Assessment	Key Characteristics
Strongest	The rating unit has the strongest BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also the strongest. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of strongest.
Very Strong	The rating unit has a very strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also very strong. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of very strong.
Strong	The rating unit has a strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also strong. It has an appropriate and diverse reinsurance program. Any additional factors are in line with an assessment of strong.
Adequate	The rating unit has an adequate BCAR score that has been relatively stable. Its quality of capital and ALM are adequate. It has an appropriate reinsurance program. Any additional factors are in line with an assessment of adequate.
Weak	The rating unit has a weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are weak. Its reinsurance program is weak. Any additional factors are in line with an assessment of weak.
Very Weak	The rating unit has a very weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are very weak. Its reinsurance program is very weak. Any additional factors are in line with an assessment of very weak.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Holding Company Impact Assessment



Holding Company Impact Assessment




- Financial Leverage
 - Unadjusted / Adjusted
- Operating Leverage
- Coverage
 - Interest & Fixed-Charge Coverage
- Financial Flexibility / Liquidity
 - Analysis of Sources and Uses
 - Access to Capital
 - Asset Allocation/Investment Risk
- Intangible Assets
- Non-Rated and/or Non-Regulated Affiliates

Balance Sheet Strength Assessment



Combined Balance Sheet Strength Assessment (Lead Rating Unit & Holding Company)

		<u>Holding Company</u>			
		Positive	Neutral	Negative	Very Negative
<u>Lead Rating Unit</u>	Strongest	Strongest	Strongest	Very Strong	Adequate
	Very Strong	Strongest	Very Strong	Strong	Weak
	Strong 	Very Strong	Strong	Adequate	Very Weak
	Adequate	Strong	Adequate	Weak	Very Weak
	Weak	Adequate	Weak	Very Weak	Very Weak
	Very Weak	Weak	Very Weak	Very Weak	Very Weak

The Baseline Assessment



Overall Balance Sheet Strength Assessment

Country Risk Tier

Combined Balance Sheet Assessment
(Rating Unit/Holding Company)

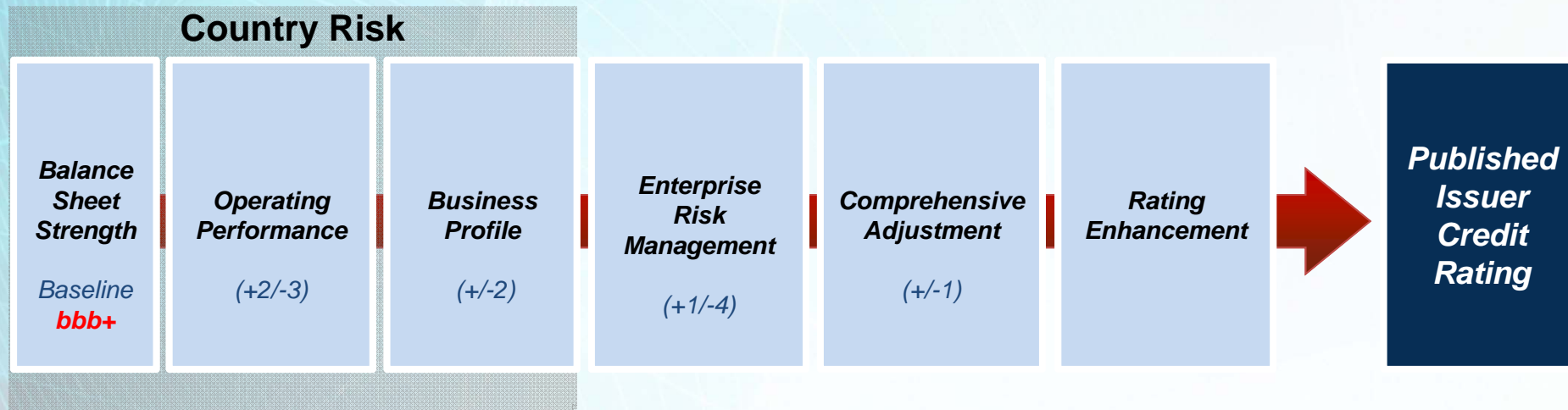
	CRT-1	CRT-2	CRT-3	CRT-4	CRT-5
Strongest	a+/a	a+/a	a/a-	a-/bbb+	bbb+/bbb
Very Strong	a/a-	a/a-	a-/bbb+	bbb+/bbb	bbb/bbb-
Strong	a-/bbb+	a-/bbb+	bbb+/bbb/bbb-	bbb/bbb-/bb+	bbb-/bb+/bb
Adequate	bbb+/bbb/bbb-	bbb+/bbb/bbb-	bbb-/bb+/bb	bb+/bb/bb-	bb-/b+/b
Weak	bb+/bb/bb-	bb+/bb/bb-	bb-/b+/b	b+/b/b-	b/b-/ccc+
Very Weak	b+ and below	b+ and below	b- and below	ccc+ and below	ccc and below



The Building Block Approach



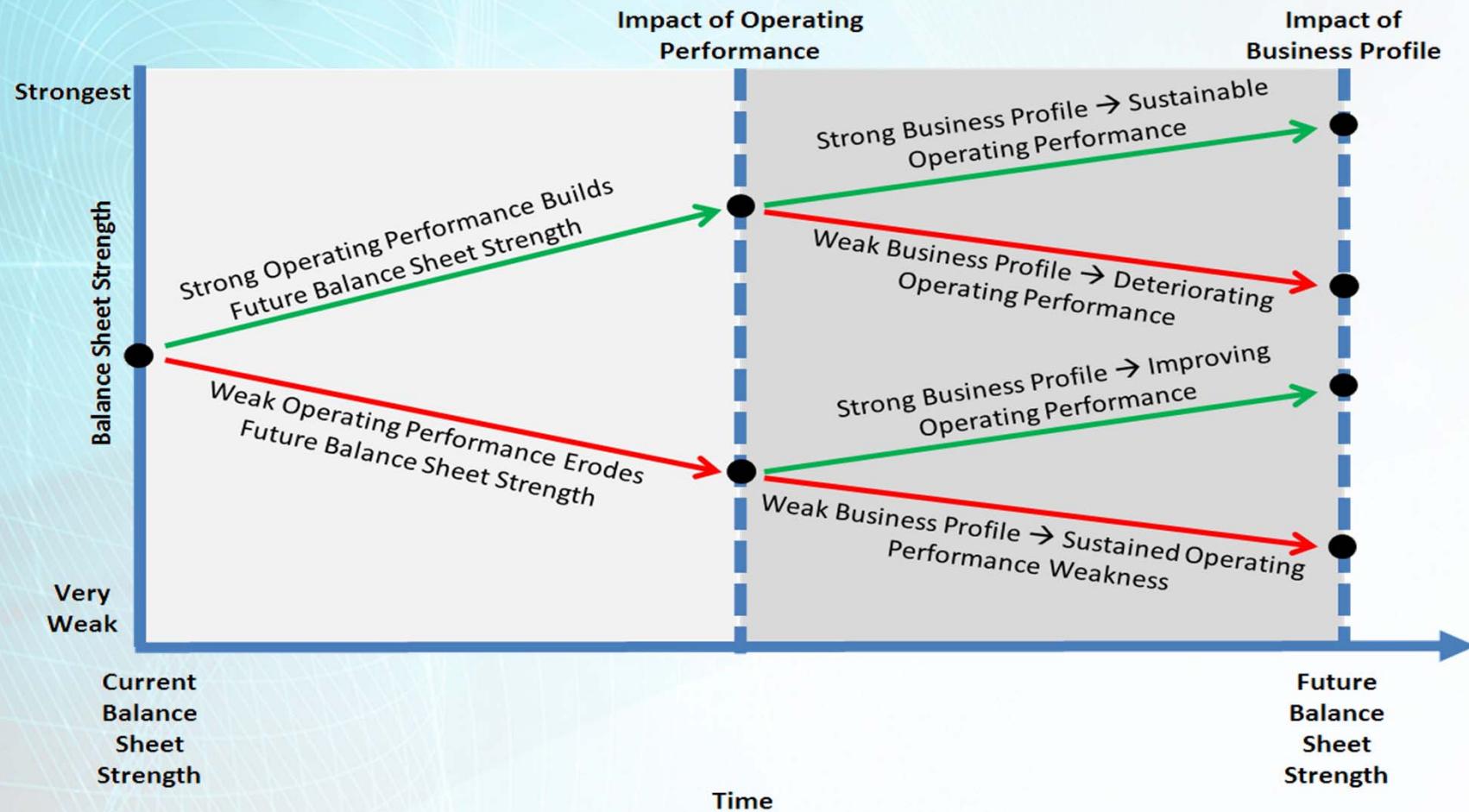
A.M. Best's Rating Process



Balance Sheet Only Goes So Far



Impact of Operating Performance and Business Profile on Balance Sheet Strength



Operating Performance



The BCRM is being updated but the fundamental rating drivers will remain the same

- Underwriting Performance
- Investment Performance
- Total Operating Earnings
- Prospective Financial Forecasts
- Other Considerations
 - Unique to LOB, region of operation, structure

Operating Performance Benchmarks




- Benchmarks ensure operating performance metrics for each insurer are being evaluated in proper framework
- Can be created using:
 - Industry composites/sub-composites
 - ICR composites
 - Other customized parameters
- May be appropriate to compare a rating against >1 benchmark
- Rating Committee has flexibility in determining the appropriate benchmark(s) for each rating unit
- Various insurance organizational types will have differing benchmarking metrics

Baseline Adjusted for Performance



- Depending on a company's operating performance, the baseline can be adjusted up or down
 - Using appropriate benchmark
 - Looking at level, trend and volatility

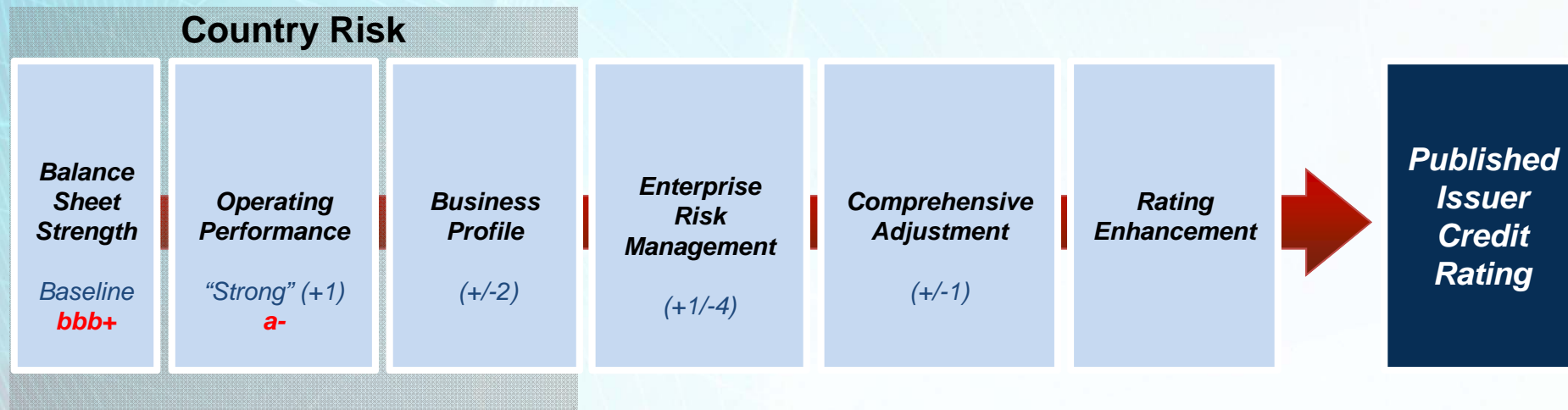
Assessment	Adjustment (Notches)	Key Operating Performance Characteristics
Very Strong	+2	Historical operating performance is exceptionally strong and consistent. Trends are positive and prospective operating performance is expected to be exceptionally strong. Volatility of key metrics is low.
 Strong	+1	Historical operating performance is strong and consistent. Trends are neutral/slightly positive and prospective operating performance is expected to be strong. Volatility of key metrics is low to moderate.
Adequate	0	Historical operating performance and trends are neutral. Prospective operating performance is expected to be neutral. Volatility of key metrics is moderate.
Weak	-1	Historical operating performance is poor. Trends are neutral/slightly negative and prospective operating performance is expected to be poor. Volatility of key metrics is high.
Very Weak	-2/3	Historical operating performance is very poor. Trends are negative and prospective operating performance is expected to be very poor. Volatility of key metrics is high.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

The Building Block Approach



A.M. Best's Rating Process



Business Profile



The BCRM is being updated but the fundamental rating drivers will remain the same

Sub-Assessment	Positive	Neutral	Negative
Product/Geographic Concentration	Significant diversification of product line /geographies	Moderate diversification of product lines / geographies	Insufficient diversification of product lines / geographies
Market Position	Increase profitable market share at a sustainable rate	Sustain profitable market share	Unable to sustain profitable market share
Pricing Sophistication & Data Quality	Provides Competitive Advantage	No Competitive Advantage/Disadvantage	Lack of sophistication creates disadvantage
Product Risk	Low Risk Offerings	Average Risk Offerings	High Risk Offerings
Degree of Competition	Low Competition	Average Competition	High Competition
Management Quality	Consistently achieves forecasts & targets	Occasionally falls short of forecasts & targets	Provides unreliable forecasts & targets
Regulatory, Event & Market Risks	Very Low or Significantly Reduced	Moderate and Stable	Very High or Significantly Increased
Distribution Channels	Created a significant competitive advantage thru distribution channels	Has not created a significant competitive advantage thru distribution channels	Faces a significant competitive disadvantage with regards to distribution

Baseline Adjusted for Profile



- Sub-assessments are qualitatively combined by analyst into a single business profile assessment
- Ultimate “weights” of each sub-assessment will vary depending on which metrics will have biggest impact on future financial strength

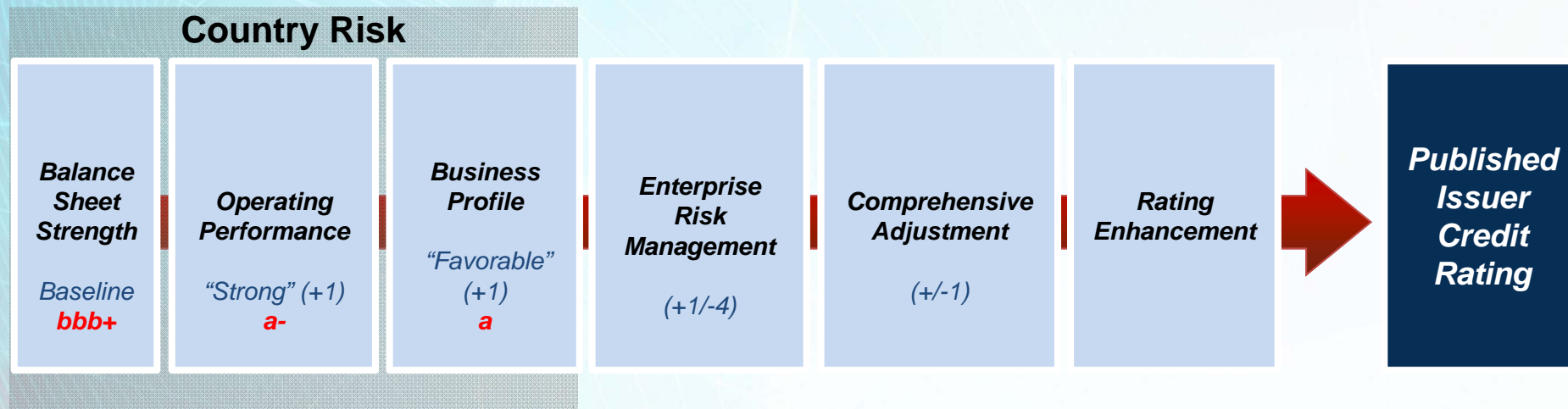
Business Profile Assessment	Adjustment (Notches)	Key Characteristics of Business Profile
Very Favorable	+2	The company’s market leadership position is unquestionable, demonstrated and defensible with high brand recognition. Distribution is seen as a competitive advantage; business lines are non-correlated and generally lower risk. Its management capabilities and data management are very strong.
 Favorable	+1	The company is a market leader with strong business trends and good control over distribution. It has diversified operations in key markets that have high to moderate barriers to entry with low competition. It has a strong management team that is able to meet projections and utilize data effectively.
Neutral	0	The company is not a market leader, but is viewed as competitive in chosen markets. It has some concentration and/or limited control of distribution. It has moderate product risk but limited severity and frequency of loss. Its use of technology is evolving and its business spread of risk is adequate.
Limited	-1	The company has a lack of diversification in geographic and/or product lines; its control over distribution is limited and undifferentiated. It faces high/increasing competition with low barriers to entry and elevated product risk. Management is unable to utilize data effectively or consistently in business decisions.
Very Limited	-2	The company faces high competition and low barriers to entry. It has a high concentration in commodity or higher risk products with very limited geographic diversity. It has weak data management. Country risk may factor into its elevated business profile risks.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

The Building Block Approach



A.M. Best's Rating Process




The BCRM is being updated but the fundamental rating drivers will remain the same

- Product & Underwriting Risk
- Reserving Risk
- Concentration Risk
- Reinsurance Risk
- Financial Flexibility Risk
- Investment Risk
- Legislative/Regulatory/Judicial/Economic Risk
- Management Risk
- Operational Risk
- Risk Appetite/Stress Testing

Baseline Adjusted for ERM



- Very strong risk management capability with a matching profile or strong risk management with a lower profile earns positive adjustment
- Risk management capability lower than the risk profile earns negative adjustment
- Downside spread reflects A.M. Best's concern that truly weak ERM can disproportionately impact financial strength

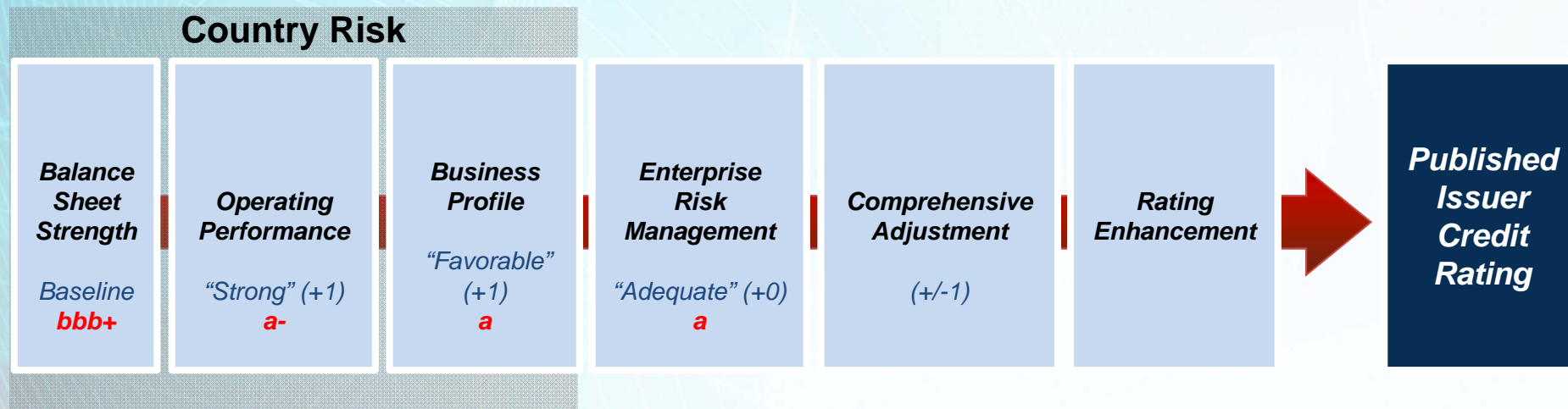
ERM Assessment	Adjustment (Notches)	Key Characteristics of ERM
Very Strong	+1	Risk management capabilities are excellent and are more than adequate for the risk profile of the company.
 Adequate	0	Risk management capabilities are good and are adequate for the risk profile of the company.
Weak	-1/2	Risk management capabilities are insufficient given the risk profile of the company.
Very Weak	-3/4	Risk management capabilities contain severe deficiencies relative to the risk profile of the company.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

The Building Block Approach




A.M. Best's Rating Process



Comprehensive Adjustment



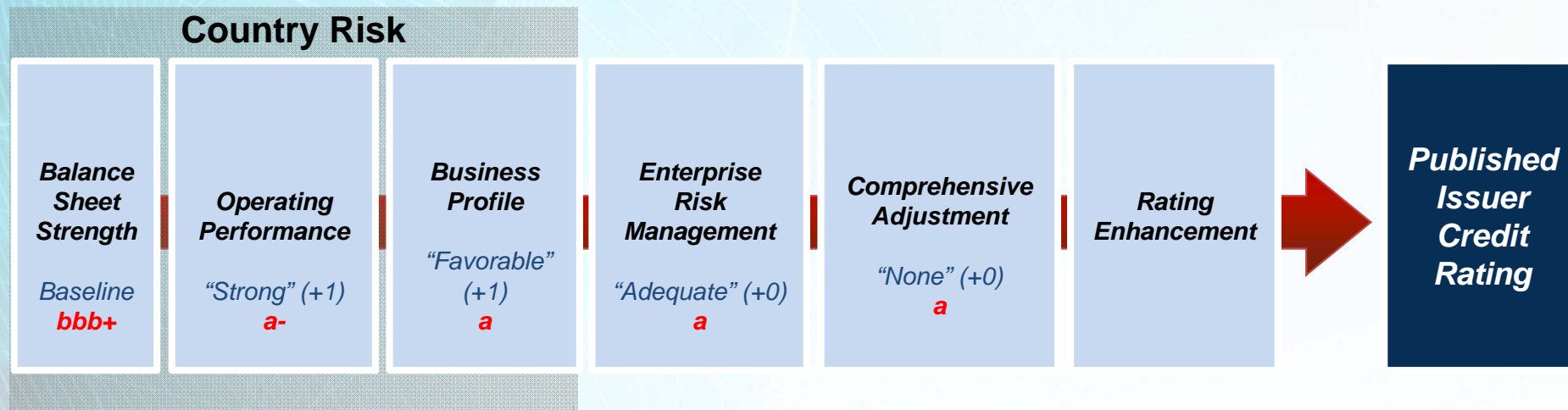
- Evaluation of key rating factors includes parameters which place limits on any one factor
- Recognizes a truly uncommon strength/weakness that is not captured through the rating process

Comprehensive Assessment	Adjustment (Notches)	Key Characteristics
Positive	+1	The company has uncommon strengths that exceed what has been captured throughout the rating process.
 None	0	The company's strengths and weaknesses have been accurately captured throughout the rating process.
Negative	-1	The company has uncommon weaknesses that exceed what has been captured throughout the rating process.

The Building Block Approach



A.M. Best's Rating Process



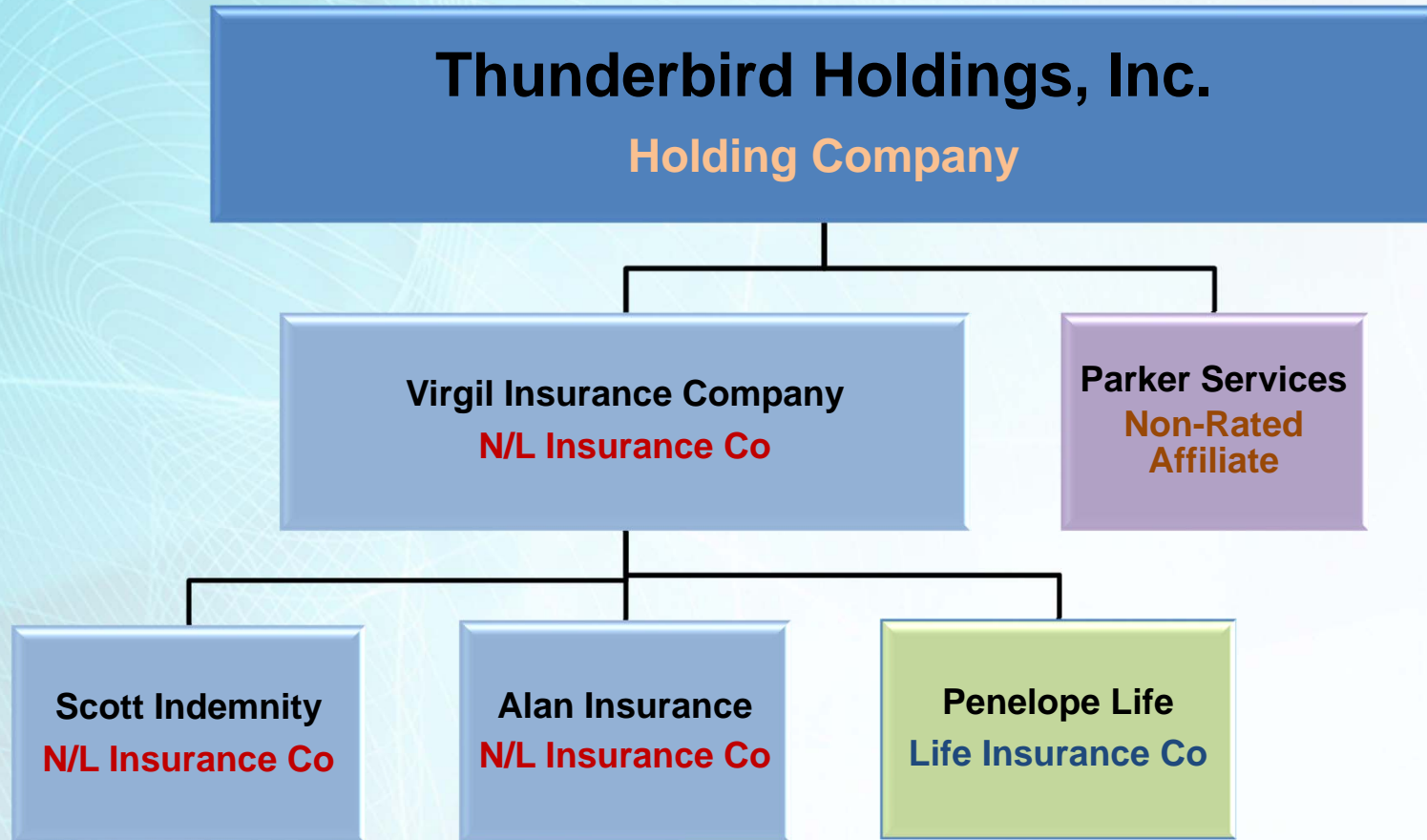
Rating Enhancement



- Non-lead rating units may be eligible for partial rating enhancement based on benefits it receives from being affiliated with the lead rating unit.
- Rating drag can also occur from negative impact of the lead rating unit on the non-lead unit.

Rating Enhancement/Drag	Adjustment (Notches)	Key Characteristics of Rating Enhancement/Drag
Typical Lift	+1 to +4	The non-lead rating unit either receives explicit support from the broader organization or is deemed materially important within the broader organization as demonstrated by its level of integration.
Neutral	0	The non-lead rating unit does not have explicit support from the broader organization and is not considered materially important within the organization.
Typical Drag	-1 to -4	The non-lead rating unit is negatively impacted by its association with the weaker affiliates of the broader organization.

Organisational Structure



Application of Rating Enhancement

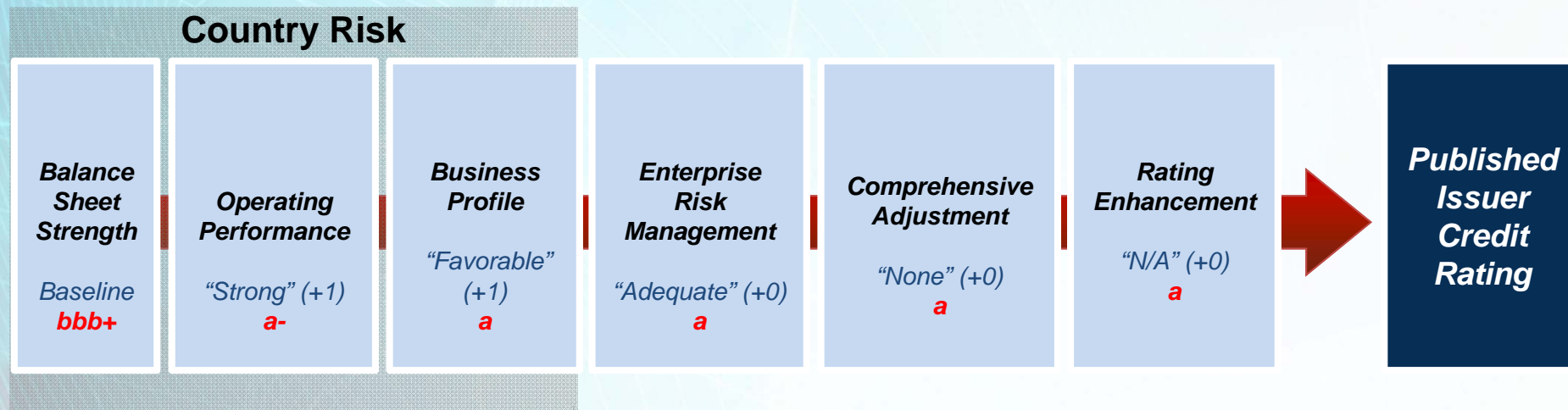


- Rating enhancement may be distributed in one of the other assessments if the analyst deems this appropriate
- **Example:** Subsidiary A is currently receiving 2 notches of lift. Analyst determines it should get 1 notch of lift for sharing the same name and systems under Business Profile. Sub A also is fully integrated into ERM so the analyst determines it should also get 1 notch under ERM. If nothing has changed, then the previous “lift” has been distributed already in Business Profile and ERM.

The Building Block Approach



A.M. Best's Rating Process



Rating recommendation of "a"

Rating Implications



- BCRM is NOT a means to change ratings although some ratings may change
- Analyst will communicate any potential rating issues as they become apparent during comment period
- Ratings impacted will be placed under review at end of comment period
 - Need to be resolved within 6 months after under review

Questions

Best's Credit Rating Methodology Update Briefing

Greg Carter
Managing Director, Analytics

March 2016
A.M. Best

