November 14, 2016

Criteria Update: BCRM and BCAR

Changes were made to promote greater transparency and consistency.

A.M. Best has released updated drafts of Best's Credit Rating Methodology (BCRM) and the criteria procedure for the U.S. property/casualty (P/C) Best's Capital Adequacy Ratio (BCAR). A.M. Best has also simultaneously released proposed revisions to the criteria procedures for the U.S. and Canadian Life/Health and Universal BCAR. A.M. Best is requesting comments from interested parties on these draft documents, which are available in the methodology section of A.M. Best's website.

The purpose of this briefing is to: (i) provide the market with an update on specific proposed changes to the BCRM and the criteria procedure for the U.S. P/C BCAR; (ii) provide an explanation of the comment process; and (iii) request responses to specific questions that are outlined at the end of this document.

The revisions to the BCRM and U.S. P/C BCAR follow the conclusion of the call for comment on June 30, 2016. A.M. Best would like to thank all respondents for their comments received through the methodology in-box. In addition, A.M. Best received feedback/questions through industry meetings, webinars and briefings that generated additional internal review of the BCRM and U.S. P/C BCAR. The changes noted below were made in an effort to promote greater transparency and consistency whenever possible.

Update on Draft BCRM and Understanding BCAR for U.S. Property/Casualty Insurers

On May 5th, 2016, A.M. Best issued a Market Briefing requesting additional comments from the marketplace. Specifically, comments were sought on the modeling of tail risk and the weighting this receives within the balance sheet strength assessment section of BCRM. In that briefing, A.M. Best also posed the following three questions to the market:

- Do you fully understand the Building Block approach outlined in the BCRM and is it sufficiently transparent? Please explain if your response is "No".
- Are there any parameters outlined for Balance Sheet Strength, Operating Performance, Business Profile, Enterprise Risk Management or Comprehensive Adjustment in BCRM that you disagree with? If so, please explain which parts you disagree with and provide alternative suggestions.
- What are your views on using VaR metrics for risk modeling in general? Do your views concerning the value of these metrics change as one goes out into the tail (e.g., VaR 99.8 and 99.9)?

Responses to these questions generated the majority of the comments received through the methodology in-box. While the comments received indicated that the BCRM was generally seen as facilitating transparency through the building block approach, there were several concerns raised regarding proposed changes to the BCAR model. All of the comments were carefully considered. A summary of the most significant changes made to the BCRM and U.S. P/C BCAR draft criteria procedure reflected in the newest releases follows:

U.S. P/C BCAR

- The basis of risk measurement for BCAR remains Value at Risk (VaR). However, the updated model replaces the calculated confidence intervals of 99.8 (1:500 return period) and 99.9

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(1:1000 return period) VaR with 99.6 (1:250 return period). The addition of VaR 99.6 (1:250 return period) is consistent with a commonly used industry practice for capital measurement and the measurement of catastrophe tail risk. The 99.8 confidence interval will continue to be run through the BCAR model; however, it will not be utilized for measurement of capital adequacy. Industry feedback was consistent in the concern of utilizing these lower probability tail events for capital measurement due to limited availability and reliability of model data, which raised the potential for greater volatility in the rating process.

- The updated model uses stochastic-based factors as opposed to conducting stochastic modeling within the BCAR model. This change was made to provide greater transparency and to allow for "what-if" scenarios. The model will continue to utilize company-specific detailed data to customize the view of balance sheet strength through the BCAR. This change had limited impact on the level of required capital.

- A.M. Best has moved catastrophe risk (B8) from a direct capital requirement to being included as part of the covariance adjustment in the net required capital calculation. This change was made after reviewing the assumption that catastrophe risk is correlated to other risks. The net PML for each confidence level uses the per-occurrence all-perils combined on a pre-tax basis. This change has generally resulted in lower net required capital.

- For the interest rate risk required capital component (B3), the expected liquidity need used in the calculation will be held constant at each of the confidence levels. Previously, the estimated losses that were used to represent the expected liquidity need increased as the confidence levels increased. The change to a constant loss amount for the expected liquidity need was made to reduce the implied correlation between the increasing interest rates and the occurrence of the event generating the need to sell assets quickly. This change has generally resulted in lower net required capital at the higher confidence levels.

BCRM

- The rating unit section of balance sheet strength that focuses on the BCAR assessment has been recalibrated to reflect the changes in VaR within the model. BCAR scores measured at various VaR levels have been changed to 95, 99, 99.5 and 99.6 (new) from 95, 99, 99.5, 99.8 and 99.9. Within the Balance Sheet Strength review, the "Very Strong" and "Strongest" BCAR assessments will also have a buffer beyond 0 at the 99.6 VaR level. This change follows the revision to the BCAR model.

- As noted above, the VaR 99.8 and 99.9 have been removed from the measurement of capital adequacy. Instead, lower probability tail events such as 99.8 will be part of the Enterprise Risk Management (ERM) discussion and will be incorporated into the scoring of the ERM building block.

- The revised BCRM reflects some restructuring in the Enterprise Risk Management section. The Risk Impact Worksheet has been refined to more explicitly highlight the review of the ERM framework and an assessment of its development. The change was designed to align the Risk Impact Worksheet more closely with the evaluation of an insurer's ERM. The risk management framework evaluation emphasizes five assessment areas: risk identification and reporting, risk appetite and tolerances, stress testing, risk management and controls, and governance and risk culture.

- The discussion of the definition of rating units within the BCRM has been revised in reaction to comments requesting greater clarity.

The Comment Process

All comments received through the methodology in-box are cataloged and reviewed. These comments are considered to determine if: (i) additional clarification is needed for the next criteria procedure update release; (ii) a change to the criteria procedure itself is appropriate; or (iii) the comment is not relevant to the criteria review. This third category typically comprises questions addressing company-specific issues that are handled by the analytical team.

When submitting comments to the methodology in-box, commenters have the option of requesting anonymity (not confidentiality) for their comments. All comments received through the methodology in-box that do not request anonymous treatment, including those received during the initial call for comment on March 10, 2016, will generally be published in their entirety, with attribution to the author/sender, at the time of implementation of the BCRM and all of its related criteria procedures. Comments requesting anonymous treatment will be paraphrased in a summary of comments without reference to the author/sender. At the time of the BCRM final release, comments may be aggregated with A.M. Best's responses noted. Please note that submitted comments may be requested in total by various regulators, in which case all comments will be included as received by A.M. Best.

Rollout of Remaining Criteria

In 2017, all remaining BCRM-related criteria procedures will be released for comment. Depending on the volume and depth of comments received, A.M. Best expects the BCRM and its related criteria procedures to become effective in late 2017. However, A.M. Best will provide updates on the status of its review as needed.

Request for Market Feedback

Market feedback is sought on several items of particular interest to A.M. Best. If possible, please respond to the following questions via the methodology comment inbox at methodology.commentary@ambest.com.

1. What is an appropriate capital treatment for deferred tax assets (DTA) when viewed within a global capital framework? How should the DTA be viewed under stress scenarios?

2. The BCRM added specific commentary on the ERM Framework Evaluation. Are there any other areas of ERM that should be considered as part of the analytical review process?

3. In the absence of modeled PMLs, how is exposure best evaluated? What is your view of estimating large potential losses without PMLs? Please provide any proxies that could be used instead.

4. What are, in your opinion, the key differences between your internal capital assessment (either based on internal capital models or regulatory capital) and A.M. Best's BCAR? Which risk charges are most different from your own internal models? What elements were included in your own models that gave you comfort that they sufficiently covered the risk?

5. Is Beta an appropriate risk measure for equity risk? If not, what is a more appropriate measure?

6. The proposed BCRM captures the risks related to domicile in an explicit manner, mainly through additional charges on investments in the BCAR and in the overall balance sheet strength assessment building block through the CRT impact. What is your view about this approach, conceptually and with regard to the magnitude of this particular impact?

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