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# PREFACE

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2007 EDITION

## AN EXPLANATION OF BEST'S RATING SYSTEM AND PROCEDURES

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### SECTION I

#### INTRODUCTION

Founded in 1899, A.M. Best Company is the world's oldest and most widely recognized rating agency exclusively dedicated to the insurance industry. Best's Ratings, which indicate the financial strength of insurance companies, cover: property/casualty, life, annuity, healthcare, reinsurance, and title insurance companies. A.M. Best provides the most comprehensive insurance ratings coverage of any rating agency, with reports and ratings maintained on over 10,600 insurance entities worldwide, in over 90 countries. A.M. Best is also a well-known and highly regarded source of information and commentary on global insurance trends and issues through a host of other products and services.

A.M. Best Company's Mission Statement is "To perform a constructive and objective role in serving the insurance marketplace as a source of reliable information and ratings dedicated to encouraging a financially strong industry through the prevention and detection of insurer insolvency." We believe that this proactive role is vital to encourage prudent management of insurance companies and to improve the industry's financial strength for the benefit of policyholders.

Best's Ratings and related financial information provide powerful tools for insurance decision-making and market research for insurance agents and brokers, risk managers,

pension managers, employee benefits administrators, investment bankers, investors, insurance executives, policyholders and consumers.

In 1900, A.M. Best first published what became known as *Best's Insurance Reports®-Property/Casualty Edition* which reported on 850 property/casualty insurers operating in the United States. This was soon followed by its companion volume, *Best's Insurance Reports®-Life/Health Edition*, which was first published in 1906 reporting on 95 legal reserve life insurers in the United States. Over the better part of a century, these two annual publications have represented the most comprehensive source of financial information on domestic insurers available.

The 2007 Property/Casualty and Life/Health Editions of *Best's Insurance Reports® United States & Canada* contain approximately 3,400 and 2,000 insurance companies, respectively, representing virtually all active insurance companies operating in the United States. In addition, the 2007 editions contain Canadian property/casualty, Canadian life and reports on United States, European, and Canadian branches.

In 1984, A.M. Best embarked on completing global coverage of the insurance industry with the publication of *Best's Insurance Reports®-Non-US Edition*, which currently reports, in CD-ROM format, on over 5,200 international property/casualty and life/health companies.

In 1999, A.M. Best expanded its rating assignments to include debt and structured finance. The issuance of securities ratings for insurers and insurance holding companies



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is a natural extension of our expertise in providing financial strength ratings and reports on insurance organizations to investors, analysts and policyholders. Best's extended focus on the insurance industry provides the basis for rating opinions in the credit markets that is unmatched in terms of an in-depth understanding of underlying insurance business fundamentals, risks and future prospects. This focus also serves as the foundation for which ratings are issued to other risk bearing institutions and entities, including captive insurers and alternative risk transfer facilities.

Within the insurance segment, Best now assigns issue ratings to debt securities, surplus notes, preferred stock and hybrid debt instruments, commercial paper, collateralized debt obligations, insurance-based liability or asset-backed securitizations and monetizations, risk-linked securities, structured financing programs, closed block securities, and institutional investment products.

In addition to our rating products and services, A.M. Best also publishes a host of other complementary products that are an extension of our knowledge of the industry. Some of these products include *Best's Aggregates and Averages* (industry-wide aggregate totals), *Best's Underwriting Guide* (an underwriter's guide to assessing over 500 commercial risks), and *Best's Loss Control Manual* (a safety engineers' guide to assessing insurance exposures and requirements). These products add to the understanding of the complexities of the insurance industry and enhance our rating evaluations as well as the value and scope of information we provide our subscribers.

A.M. Best currently provides over 50 publications and services to meet the needs of our customers who require timely, accurate and comprehensive information on this dynamic industry. A.M. Best is dedicated to providing our subscribers with the most useful and up-to-date information and ratings available in the insurance industry.

While Best's Financial Strength Ratings reflect our **opinion** as to a company's financial strength and ability to meet its ongoing obligations to policyholders, they are **not a warranty**, nor are they a recommendation of a specific policy form, contract, rate or claim practice.

## SECTION II

### SOURCES OF INFORMATION

The primary source of the information presented in this publication is each insurance company's 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. In the United States, most of these financial statements are prepared in accordance with statutory accounting requirements established by the National Association of Insurance Commissioners (NAIC) and administered by the respective states. Outside the United States, these statements are presented in accordance with customs or regulatory requirements of the country of

domicile, and there may be significant variations in accounting standards or in methods of reporting from one country to another. These differences are imbedded in the accounting principles used, the valuation of assets and liabilities, and the treatment of taxes.

Financial data is usually received in the currency of the country where the company is headquartered, and our reports are generally presented in that currency as well as in U.S. dollars. Our reports represent a variety of reporting dates as the fiscal year utilized by companies vary according to traditional reporting periods or regulatory requirements.

Our comprehensive review of a company's financial strength is supplemented by publicly available documents, such as Securities and Exchange Commission (SEC) filings in the United States, Generally Accepted Accounting Principles (GAAP), or International Accounting Standards (IAS) financial statements. Other sources of information may include audit reports prepared by certified public accountants or actuaries, loss reserve reports prepared by loss reserve specialists, confidential documents provided by company management, our proprietary Background and Supplemental Rating Questionnaires, and annual business plans.

While the information contained in our reports is obtained from sources believed to be reliable, its accuracy is not guaranteed. We do not audit company financial records or statements and, therefore, cannot attest as to their accuracy.

Consequently, no representations or warranties are made or given as to the accuracy or completeness of the information presented herein, and no responsibility can be accepted for any error, omission or inaccuracy in our reports. Caution should be used in the interpretation and comparison of the information shown due to the differences, which may exist between companies' financial reporting standards, insurance operations, and parent/subsidiary relationships.

## SECTION III

### OBJECTIVE OF BEST'S RATING SYSTEM

#### Financial Strength Ratings

The objective of Best's Financial Strength Rating system is to provide an opinion of an insurer's financial strength and ability to meet ongoing obligations to its policyholders. The assigned rating is derived from an in-depth evaluation of a company's balance sheet strength, operating performance, and business profile as compared to Best's quantitative and qualitative standards. An important component of the evaluation process requires an interactive exchange of information with the insurance company's management. In addition, our opinions are also derived from the evaluation of country risk, which includes corporate and political governance, economic environment and insurance industry environment.

As shown in the accompanying table, Best's Financial Strength Ratings range from our highest, A++ (Superior), to



our lowest, F (In Liquidation). Companies that subscribe to our interactive rating service are assigned a Best's Rating (A++ to F). Best may assign Best's Public Data Ratings (noted by the "pd" subscript) to other insurers, as well as to U.S. Health Maintenance Organizations (HMOs) that do not subscribe to our interactive rating process. These Public Data Ratings will be assigned where, in Best's opinion, ratings are needed due to market demand.

#### Type of Ratings Opinions

	Best's Ratings	
	Interactive	Public Data
Rating Scale	A++ to F	A++ pd to D pd
Evaluation	Quan. & Qual.	Quan. & Qual.
Interaction with Mgmt.	Yes	No
Sufficient Exp. & Size	Yes	Yes

Best's Financial Strength Rating opinions are divided into two broad categories - Secure and Vulnerable. This delineation provides our subscribers with a gauge of how A.M. Best views a company's ability to meet its obligations to policyholders. Based on *Best's Insolvency Studies*, Secure rated companies have experienced a very low failure frequency, which is significantly lower than Vulnerable rated companies (and companies unrated or not followed by A.M. Best). Hence the justification for the two categories.

In Best's opinion, the highest rated Secure companies have a very strong ability to meet their ongoing obligations to policyholders, while the lowest rated Secure companies have a good ability. The time frame for the ability of Secure companies to meet their current and ongoing obligations to policyholders varies. The higher a company's Secure rating, the greater its ability to withstand adverse changes in underwriting and economic conditions over longer periods of time. The time frame in which Vulnerable companies are expected to meet their obligations also varies. "Fair", "Marginal" and "Weak" rated companies may only have a current ability to pay claims, while companies rated "Poor", "Under Regulatory Supervision" and "In Liquidation" may not have an ability to fully meet their current obligations to policyholders.

#### Issuer Credit Ratings and Debt Ratings

A.M. Best also assigns Issuer Credit Ratings and Debt Ratings to insurance operating companies and holding companies. While our annual publications include only Financial Strength Ratings, Issuer Credit Ratings and Debt Ratings can be found along with Financial Strength Ratings on the A.M. Best website, [www.ambest.com](http://www.ambest.com).

A Best's Long-Term Issuer Credit Rating is an opinion as to the ability of the issuer to meet its ongoing senior financial obligations. These ratings are assigned to insurance companies, holding companies, or other legal entities authorized to issue financial obligations.

A Best's Short-Term Issuer Credit Rating is an opinion as to the ability of the issuer to meet its senior financial commitments on obligations maturing in generally less than one year.

A Best's Long-Term Debt Rating is an opinion as to the issuer's ability to meet its ongoing financial obligations to security holders when due. These ratings are assigned to debt and preferred stock issues.

A Best's Short-Term Debt Rating is an opinion as to the issuer's ability to meet its financial obligations having maturities generally less than one year, such as commercial paper.

## SECTION IV

### BEST'S RATING SCALE

The Best's Financial Strength Rating scale is comprised of 16 individual ratings grouped into 10 categories, consisting of three **Secure** categories of "Superior", "Excellent" and "Good" and seven **Vulnerable** categories of "Fair", "Marginal", "Weak", "Poor", "Under Regulatory Supervision", "In Liquidation", and "Rating Suspended".

#### Financial Strength Ratings

##### Secure

###### **A++ and A+ (Superior)**

Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders.

###### **A and A- (Excellent)**

Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing obligations to policyholders.

###### **B++ and B+ (Good)**

Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders.

##### Vulnerable

###### **B and B- (Fair)**

Assigned to companies that have, in our opinion, a fair ability to meet their ongoing obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.

###### **C++ and C+ (Marginal)**

Assigned to companies that have, in our opinion, a marginal ability to meet their ongoing obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.

###### **C and C- (Weak)**

Assigned to companies that have, in our opinion, a weak ability to meet their ongoing obligations to policyholders, but are financially very vulnerable to adverse changes in underwriting and economic conditions.



### D (Poor)

Assigned to companies that in our opinion, may not have an ability to meet their ongoing obligations to policyholders and are financially extremely vulnerable to adverse changes in underwriting and economic conditions.

### E (Under Regulatory Supervision)

Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by an insurance regulatory authority under a significant form of supervision, control or restraint, whereby they are no longer allowed to conduct normal ongoing insurance operations. This would include conservatorship or rehabilitation, but does not include liquidation. It may also be assigned to companies issued cease and desist orders by regulators outside their home state or country.

### F (In Liquidation)

Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company. Note: Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.

### S (Rating Suspended)

Assigned to rated companies that have experienced sudden and significant events affecting their balance sheet strength or operating performance whereby the rating implications cannot be evaluated due to a lack of timely or adequate information.

### Long-Term Issuer Credit Ratings and Long-Term Debt Ratings

Best's Long-Term Issuer Credit Rating and Long-Term Debt Rating scale is comprised of 22 individual ratings grouped into 8 categories, consisting of four **Investment Grade** categories of "Exceptional," "Very Strong," "Strong" and "Adequate" and four **Non-Investment Grade** categories of "Speculative," "Very Speculative," "Extremely Speculative" and "In Default."

#### Investment Grade

aaa	(Exceptional)
aa+ and aa and aa-	(Very Strong)
a+ and a and a-	(Strong)
bbb+ and bbb and bbb-	(Adequate)

#### Non-Investment Grade

bb+ and bb and bb-	(Speculative)
b+ and b and b-	(Very Speculative)

ccc+ and ccc and ccc- and cc and c	(Extremely Speculative)
d	(In Default)

While the above definitions apply to entities which do not issue insurance obligations, A.M. Best also assigns Issuer Credit Ratings to all rated insurance companies. In addition, it should also be noted that A.M. Best assigns Issuer Credit Ratings to publicly-traded holding companies, where a significant portion of cash flow is provided by insurance operations. The definitions applied to insurance companies that are assigned an Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Good; (bb) - Fair; (b) - Marginal; (ccc,cc) - Weak; (c) - Poor; (rs) - Regulatory Supervision/Liquidation.

### Short-Term Issuer Credit Ratings and Short-Term Debt Ratings

Best's Short-Term Issuer Credit Rating and Short-Term Debt Rating scale is comprised of 6 individual ratings grouped into 6 categories, consisting of four **Investment Grade** categories of "Strongest," "Outstanding," "Satisfactory" and "Adequate" and two **Non-Investment Grade** categories of "Speculative" and "In Default."

#### Investment Grade

AMB-1+	(Strongest)
AMB-1	(Outstanding)
AMB-2	(Satisfactory)
AMB-3	(Adequate)

#### Non-Investment Grade

AMB-4	(Speculative)
d	(In Default)

## SECTION V

### RELEASE OF FINANCIAL STRENGTH RATINGS

Best's Financial Strength Rating opinions are formally evaluated at least once every 12 months and also following any significant event. The formal review is based on comprehensive information provided to A.M. Best, which includes annual and quarterly (if available) financial statutory statements filed with regulators and Securities and Exchange Commission (SEC) of the United States filings (if applicable),



together with other publicly available financial statements prepared under Generally Accepted Accounting Principles (GAAP) or International Accounting Standards (IAS), and confidential documents including Best's Supplemental Rating Questionnaires (for interactive Best's Ratings).

With our interactive Best's Ratings, analysts maintain rating contact with company managements throughout the year and monitor each company's performance. Ratings are continually re-evaluated for changes that might arise during the year, or in conjunction with our ongoing dialogue with company managements.

Ratings are reviewed and released throughout the year following a formal annual review, including upgrades, downgrades, affirmations, new assignments or ratings placed under review (see section X, Affiliation Codes and Rating Modifiers). In addition, all ratings are reviewed following the receipt of the annual statutory and GAAP financial statements as well as quarterly filings to ensure there have been no material changes since the last formal rating review. Moreover, due to event-driven circumstances, rating actions may be released outside of the scheduled formal review process. Situations such as mergers or acquisitions, dramatic changes in financial information, legislative/regulatory actions or current events are examples of occasions that may instigate a rating action or change. Best's Ratings are updated and are released immediately through *Best's Internet Service* via [www.ambest.co.uk](http://www.ambest.co.uk) (United Kingdom), [www.ambest.com](http://www.ambest.com) (United States), [www.ambest.com.hk](http://www.ambest.com.hk) (Hong Kong) - A.M. Best's Web Sites. Rating upgrades and downgrades, as well as initial ratings are also released through *Best's Ratings Monitor*, our most timely and complete release of ratings in print. Selected rating changes and new ratings are published on a monthly basis in *Best's Review*<sup>®</sup>, the monthly magazine. Finally, updated *Best's Credit Reports* are available shortly after the publication of a company's updated rating assignment.

## **Rating Outlooks**

A rating outlook indicates the potential future direction of a company's rating over an intermediate period, generally defined as the next 12 to 36 months. Outlook indications can be positive, negative or stable. A *positive* outlook is placed on a company's rating if its financial and market trends are favorable, relative to its current rating level, and if they continue, the company has a good possibility of having its rating upgraded. In contrast, a *negative* outlook is placed on a company's rating that is experiencing unfavorable financial and market trends, relative to its current rating level, and if they continue, the company has a good possibility of having its rating downgraded. A *stable* outlook is placed on a company's rating to indicate that it is experiencing stable financial and market trends, and that there is a low likelihood that its rating will change in the near term. Rating outlooks appear immediately following the rating rationale section of the company's *Best's Credit Report*.

## **Rating History**

To enable the reader to track trends, Best's Insurance Reports contains a Five Year History section and Best's Key Rating Guide presents the five latest rating events.

# SECTION VI

## **ASSIGNMENT OF BEST'S RATINGS**

The assignment of an interactive Best's Financial Strength Rating (A++ to F) involves a comprehensive quantitative and qualitative analysis of a company's **balance sheet strength, operating performance, and business profile.**

For our interactive Best's Financial Strength Ratings, we believe this balanced approach of evaluating a company on both quantitative and qualitative levels provides a better insight of a company, and results in a more discerning and credible rating opinion. We believe our more refined rating process has significantly improved the predictive value of our ratings in identifying financially secure or vulnerable insurance companies over time.

Risk Management is an important aspect of any insurance company operation. Enterprise Risk Management (ERM) has grown in importance as companies look to consider the correlation of many risks that they have historically managed independently, or deal with emerging risk issues inherent in many of today's more sophisticated product offerings.

The analysis of ERM is an integral part of the rating analysis and discussions with all rated companies. A company's risk management capabilities are considered in the qualitative assessment of all three rating areas, Balance Sheet Strength, Operating Performance and Business Profile.

The interpretation of quantitative measurements involves the incorporation of more qualitative considerations into the process that may impact prospective financial strength. Our quantitative evaluation is based on an analysis of each company's reported financial performance, utilizing over 100 key financial tests and supporting data. These tests, which underlie our evaluation of balance sheet strength and operating performance, vary in their importance depending upon a company's characteristics.

In assigning a Best's Financial Strength Rating, additional consideration is given to balance sheet strength for those companies that are exposed to shorter tail liabilities (less than 2-3 years) or those companies maintaining extremely strong balance sheet strength. Companies exposed to short tail liabilities face fewer unknown losses, reducing long term risk. Alternatively, those companies exposed to long tail liabilities (over 7 years) face greater uncertainty and risk and more importance is placed on operating performance which will need to be strong to sustain or enhance balance sheet strength over the long term. Those companies with an extremely strong balance sheet are given additional consideration while improving their weak profitability.



A company's quantitative results are compared with industry composites as established by A.M. Best. Composite standards are based on the performance of many insurance companies with comparable business mix and organizational structure. In addition, industry composite benchmarks are adjusted from time to time for systemic changes in underwriting, economic, and regulatory market conditions to ensure the most effective and appropriate analysis.

For many insurance groups, Best's quantitative evaluation is based on a consolidated approach applied to an insurance group or pool, recognizing the importance of inter-company arrangements that financially link individual insurers by investment, pooling, or reinsurance agreements. Such arrangements are common in the property/casualty industry.

The assignment of Best's Public Data Ratings ("pd" subscript) also incorporates analysis of balance sheet strength, operating performance and business profile. However, the analysis does not generally involve interaction with company management.

In some instances, Best's Financial Strength Ratings are assigned to newly formed companies or companies that do not meet our minimum size requirements, that maintain strategic affiliations with other rated companies, or have demonstrated long histories of relatively stable operating performance. Best's Ratings are also assigned to companies that have achieved or will likely achieve significant market share or acquired seasoned books of business. In general, Best's Financial Strength Ratings may be assigned to new companies with experienced management and credible business plans. In all cases, these companies comply with Best's request for supplemental information and/or meetings with management.

Over the years, regulatory and tax issues, in addition to market dislocations, have resulted in a wave of newly created insurance and reinsurance companies. A.M. Best has actively responded to the growing market demand by agents, brokers, lenders, capital markets participants and corporate clients for information on newly formed insurance and reinsurance entities. The start-ups rated by A.M. Best are subject to the same assessment of balance sheet strength and business profile as established companies receiving an interactive rating assignment. However, because these new entities have yet to demonstrate a track record in operating performance, Best also applies a stringent set of qualitative standards upon which initial ratings may be issued.

Some of the more specific considerations utilized by A.M. Best in assigning ratings to start-up insurers / reinsurers are broken down into four critical areas: management, sponsorship, strategy, initial capitalization. However, in addition to these factors, certain conditions must be present, transcending all other rating considerations for Best to proceed with an initial rating assignment.

- Initial financing either must be in place or must be expected to be executed concurrent to the initial rating assignment.
- Appropriate management, staff and operational infrastructure must be available to support initial activities.
- A formal plan to follow-up on the execution of the initial business plan, along with a formal process to monitor

the company's strategic and financial development, must be agreed to by A.M. Best and company management.

## **Parent / Subsidiary Relationships**

The implicit or explicit support of a parent or affiliate can affect an insurer's financial strength and therefore its Best's Rating. The assessment of support involves a top-down, bottom-up analysis of the parent organization and each subsidiary. This analysis enables A.M. Best to classify a company in one of three categories from which its stand-alone rating will receive: full rating uplift, partial rating uplift or no rating uplift.

- Subsidiaries that receive full rating uplift and the rating of their parent or that of the company with which they maintain the greatest degree of affiliation, are viewed as integral to the group's strategy and critical to its ongoing success and viability. These subsidiaries are fully integrated into the group's operations, usually carry the group name and are well established in their particular markets. Additionally, the operating performance and stand-alone capitalization of the subsidiary is comparable to that of its parent and has historically contributed to the financial strength of the parent.

- Subsidiaries that receive partial rating uplift share many of the same characteristics as a subsidiary receiving full rating uplift, but differ in their degree of affinity. Such subsidiaries do not receive the parent's/affiliates rating, however, their stand-alone rating usually benefits from their group affiliations.

- Subsidiaries receiving no rating uplift are usually viewed as being opportunistic in nature. These subsidiaries carry a rating based on an evaluation of their stand-alone financial strength and receive no benefit of potential support from the group as they are incidental to the group's overall strategy and are insignificant contributors to the group's operating performance.

## SECTION VII

### **BALANCE SHEET STRENGTH**

In determining a company's ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its balance sheet strength. An analysis of a company's **underwriting, financial, operating** and **asset leverage** is very important in assessing its overall balance sheet strength.

Balance sheet strength measures the exposure of a company's surplus to its operating and financial practices. A highly leveraged, or poorly capitalized company can show a high return on surplus, but may be exposed to a high risk of instability. A conservative level of leverage or capitalization enables an insurer to better withstand catastrophes, unexpected losses and adverse changes in underwriting results, fluctuating investment returns or investment losses, and changes in regulatory or economic conditions.

**Underwriting leverage** is generated from four sources: current premium writings, annuity deposits, reinsurance, and



loss or policy reserves. A.M. Best reviews these forms of leverage to analyze changes in trends and magnitudes. To measure a company's exposure to pricing errors in its book of business, we review the ratio of gross and net premiums written to capital. To measure the company's credit exposure and dependence on reinsurance, we review the credit quality of a company's reinsurers and ratio of reinsurance premiums and reserves ceded and related reinsurance recoverables to surplus. To measure the company's exposure to unpaid obligations, unearned premiums and exposure to reserving errors, we analyze the ratio of net liabilities to surplus.

In order to assess whether or not an individual company's underwriting leverage is prudent, a number of factors unique to the company are taken into consideration. These factors include types of business written, spread of risk, quality and appropriateness of its reinsurance program, quality and diversification of assets, and adequacy of loss reserves.

A.M. Best reviews a company's **financial leverage** in conjunction with its underwriting leverage in forming an overall opinion of a company's balance sheet strength. Financial leverage through debt, or debt-like instruments (including financial reinsurance), may place a call on an insurer's earnings and strain its cash flow. Similar to underwriting leverage, excessive financial leverage at the operating or holding company can lead to financial instability. As such, the analysis is conducted at both the operating company and holding company levels, if applicable.

To supplement its assessment of financial leverage, A.M. Best also reviews a company's **operating leverage**. A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on insurer's earnings and cash flow. As such, for analytical purposes, generally debt obligations viewed by A.M. Best as operating leverage would be excluded from the calculation of financial leverage.

A.M. Best also evaluates **asset leverage**, which measures the exposure of a company's surplus to investment, interest rate and credit risks. Investment and interest rate risks measure the credit quality and volatility associated with the company's investment portfolio and the potential impact on its balance sheet strength.

A company's underwriting, financial and asset leverage is also subjected to an evaluation by Best's Capital Adequacy Ratio (BCAR) which calculates the Net Required Capital to support the financial risks of the company associated with the exposure of its investments, assets and underwriting to adverse economic and market conditions such as a rise in interest rates, decline in the equity markets and above normal catastrophes. This integrated stress analysis evaluation permits a more discerning view of a company's balance sheet strength relative to its operating risks. A company's BCAR result is useful in determining a company's balance sheet strength.

A.M. Best takes a consolidated approach to insurance groups and assigns a common BCAR result to multiple

member companies that are linked together through ownership, inter-company pooling, or reinsurance arrangements.

## Capitalization Tests

- **Change in Net Premiums Written and Deposits:** A company should demonstrate an ability to support controlled business growth with quality surplus growth from strong internal capital generation.

- **Net Premiums Written to Capital & Surplus:** This ratio compares a company's net retained premium to its capital and surplus. This ratio measures the company's exposure to pricing errors in its current book of business.

- **Net Liabilities to Capital & Surplus:** This ratio measures a company's exposures to errors of estimation in its loss reserves and all other liabilities. The higher the loss reserve leverage the more critical a company's solvency depends upon having and maintaining adequate reserve levels.

- **Net Leverage:** This ratio measures the combination of a company's net exposure to pricing errors in its current book of business and errors of estimation in its net liabilities after reinsurance in relation to capital and surplus.

- **Ceded Reinsurance Leverage:** This ratio measures a company's dependence upon the security provided by its reinsurers and its potential exposure to adjustments on such reinsurance.

- **Gross Leverage:** This ratio measures a company's gross exposure to pricing errors in its current book of business, to errors of estimating its liabilities, and exposure to its reinsurers.

- **Best's Capital Adequacy Ratio (BCAR):** The BCAR Ratio compares an insurer's adjusted surplus relative to the required capital necessary to support its operating and investment risks. Companies deemed to have "adequate" balance sheet strength normally generate a BCAR score of over 100% and will usually carry a Secure Best's Rating. Companies deemed to have strong balance sheet strength generate a BCAR score over 200%. The level of capital required to support a given rating level varies by company, depending on its operating performance and business profile.

Adjusted surplus is reported surplus plus/minus adjustments made to provide a more comparable basis for evaluating balance sheet strength. Such modifications include adjustments related to equity in unearned premiums, loss reserves, and assets. Certain off-balance sheet items are also deducted from reported surplus, such as encumbered capital, debt service requirements, potential catastrophe losses and future operating losses.

Net Required Capital, for property/casualty insurers, is calculated as the necessary level of capital to support seven broad risk categories, including: B1 (Fixed Income Securities); B2 (Equity Securities); B3 (Interest Rate); B4



(Credit); B5 (Loss and Loss Adjustment Expense (LAE) Reserves); B6 (Net Written Premiums); and B7 (Business Risk). Net Required Capital represents the arithmetic sum of capital required to support each of the risk categories reduced by a covariance adjustment. The covariance adjustment reduces a company's total capital requirement by recognizing that the risks associated with many of the seven categories are independent and may not occur at the same time.

For life/health insurers this ratio incorporates into a single measure the financial impacts of several distinct risk components. BCAR utilizes the C1 (Credit Risk), C2 (Underwriting Risk), C3 (Interest Rate Risk) and C4 (Business Risk) classifications, from which a required level of capital to support these broad risks is derived. BCAR contains a covariance adjustment, in recognition of the fact that certain risk categories are mutually exclusive.

Generally, over two-thirds of a property/casualty company's net capital requirement is generated from its B5 (Loss and LAE Reserves) and B6 (Net Written Premiums) risk components which are influenced by a company's business profile including distribution of premium by line and location, size, underwriting leverage, loss reserve adequacy and stability, and premium rate adequacy. Conversely, generally over two-thirds of a life insurance company's net capital requirements is generated by C1 (Credit Risk) and C3 (Interest Rate Risk).

## **Catastrophe Stress Test**

In addition to requiring a company to maintain capitalization that can withstand the net, after tax, hit to surplus from an initial catastrophe event, A.M. Best analysts perform a further stress test on the capitalization of a property/casualty insurer by adjusting BCAR for a second catastrophic event.

As part of this analysis, a company's overall catastrophe risk management process is evaluated and considered along with the financial flexibility of a company to determine its ability to first avoid a material loss to capital, and second, to respond to any significant capital deterioration from such events. Those companies that demonstrate strength in both of these areas will be afforded the greatest amount of flexibility within A.M. Best's stress test of catastrophe exposure.

A.M. Best believes the keys to strong catastrophe risk management are: ensuring data quality in terms of the integrity, completeness and timeliness of the data collected; monitoring aggregate and potential loss exposures on a frequent and consistent basis; and, implementing controls that establish acceptable levels of exposure and integrate catastrophe management into the underwriting process.

This analysis provides a preview of a company's BCAR score as if the event actually occurred, and reflects the notion that the company's exposure remains the same after the event as it was on the day of the event.

## **Capital Structure/Holding Company**

Holding companies (if present) and their associated capital structures can have a significant impact on the over-

all financial strength of an insurance company subsidiary. Holding companies can provide subsidiaries with a level of financial flexibility, including capital infusions, access to capital markets, and in some cases, additional cash flow sources from other operations. Likewise, debt and other securities are typically obligations of a holding company which, depending on the magnitude of these obligations, can reduce the financial flexibility of the enterprise and potentially place a strain on future earnings and inhibit surplus growth at an insurance subsidiary.

A.M. Best reviews an insurer's capital structure and its holding company's capital structure to determine if it is sound and unencumbered. This review includes an assessment of the quality of capital with a focus on the amount, composition, and amortization schedule of intangible assets as well as the presence of surplus notes at the operating company.

A holding company can have various types of financial instruments including debt securities, preferred stocks or other hybrid securities in its capital structure. For mutual companies, surplus notes can exist as a component of overall surplus. A.M. Best reviews the relative debt and equity characteristics of a particular capital security in determining overall financial leverage. Our review focuses on specific terms and features of securities, including the coupon and dividend rates, repayment terms and financial and other covenants. Insurance subsidiaries generally fund debt service and other obligations of their holding company through a combination of dividends, tax sharing payments and other expense allocation agreements with their holding company. As such, A.M. Best measures the extent to which an insurance company's earnings or the holding company's cash flow can cover interest and other fixed obligations.

Integral to an insurer's rating assignment is our assessment of a company's ability to meet the debt service and other obligations associated with its parent's capital structure and the risks that a capital structure imposes on a company.

Additionally, Best employs a top-down view of the total organization, which includes a review of the non-insurance operations of a holding company, to determine their impact, if any, on the overall financial strength of the insurance operations.

## **Quality and Appropriateness of Reinsurance Program**

Reinsurance plays an essential role in the risk-spreading process and provides insurers, with varying degrees of financial stability. As a result, we evaluate a company's reinsurance program to determine its appropriateness and credit quality. A company's reinsurance program should be appropriate relative to its policy limits and underwriting risks, catastrophe exposures, business, financial capacity and the credit quality of the reinsurers involved. In addition, a reinsurance program should involve time-risk transfer and include reinsurers of good credit quality, since in



the event of a reinsurer's failure to respond to its share of a loss, the reinsured or counterparty would have to absorb a potentially large loss in its entirety.

To be considered adequate for catastrophe protection, a program needs to protect a property/casualty company from impairment or insolvency from large shock-losses such as a 100-year windstorm, or a 250-year earthquake, or its annual aggregate loss exposure. In addition, reinsurance should also provide protection from a series of smaller storm losses that do not trigger recovery from a traditional catastrophe reinsurance program. In addition to spreading risk, reinsurance can be utilized to leverage a company's surplus to enable it to write more business than would otherwise be possible.

For life/health companies, a reliable reinsurance program must consider sound risk management practices to provide the company with protection against adverse fluctuations in experience. Since these risk transfer agreements on an underlying policy or policies indemnify the company for insurance risks, prudent evaluation of the economic impact on a company's life, health, and annuity operations is critical. Incorporating reinsurance to manage a company's financial risk that includes mortality, morbidity, lapse or surrender, expense, and investment performance, presents a competitive risk to an insurer's future growth prospects and long-term viability. Therefore, the range of reinsurance must be evaluated with the company's ability to manage its growth relative to demands for life and health insurance coverages under existing economic and regulatory environments.

An insurer's ability to meet its financial obligations can become overly dependent upon the performance of its reinsurers. A company can also become exposed to the state of reinsurance markets in general. A significant dependency on reinsurance can become problematic if a major reinsurer of the company becomes insolvent or disputes claims coverage. It can also become a problem if general reinsurance rates, capacity, terms and conditions change dramatically following an industry event. The more a company is dependent upon reinsurance, the more vulnerable its underwriting capacity becomes to adverse changes in the reinsurance market. The greater this dependency, the greater our scrutiny of a company's reinsurance program to determine its appropriateness and credit quality and whether it is temporary or permanent in nature.

### **Adequacy of Loss/Policy Reserves**

An evaluation of the adequacy of an insurer's reported reserves is essential to an evaluation of its profitability, leverage (capitalization) and liquidity. Net income and policyholders' surplus are directly affected by changes in reported reserves. While we do not audit a company's reserves, we rely on the reserve adequacy opinions of certified actuaries (internal and third party) to supplement our review.

Reserves play an important role in determining the balance sheet strength and flexibility of an insurance carrier, as

well as its underlying profitability. The ability to predict ultimate reserve requirements is as much an art form as it is a science. Actuaries who certify a company's reserves typically provide management with a range within which loss and loss adjustment expense reserves are deemed adequate. The range of reserve adequacy estimated by actuaries can be very significant. For casualty-oriented insurers, a 25% deficiency in current reserves may exceed policyholders' surplus and, therefore, render them technically insolvent.

For property/casualty companies, we evaluate reserving trends through our proprietary loss reserve model to measure any equity imbedded in a company's loss reserves.

Upon determining our estimate for a company's ultimate loss reserve position, it is discounted to determine an economic loss reserve position. Any difference (deficiency or redundancy) between this economic reserve level and a company's carried loss reserve level is then applied to our proprietary capital adequacy model (BCAR).

This loss reserve equity adjustment, which can be sizable for property/casualty insurers, enables A.M. Best to "level the playing field" within our rating evaluation and better discriminate between companies that historically have under-reserved from those that have strong loss reserve positions.

For life/health companies, we review the valuation methodology, interest assumptions and degree of conservatism in the establishment of life, health and annuity reserves. We also evaluate the degree of uncertainty in policy reserves, recognizing that they are only actuarial estimates of future events. If the degree of uncertainty exceeds any equity in the reserves, and is large in relation to net income and policyholders' surplus, our confidence declines in a company's reported profitability, liquidity, and leverage (capitalization).

### **Key Loss Reserve Tests:**

- **Loss and LAE Reserves to Capital & Surplus:** This ratio measures the trend and magnitude of loss reserves to capital surplus. The higher the multiple of loss reserves to surplus, the more critical reserve adequacy becomes to an insurer's solvency.
- **Development to Capital & Surplus:** This ratio reflects the degree to which year-end capital surplus was either overstated (+) or understated (-) in each of the past several years.
- **Development to NPE:** If premium growth has been relatively steady, and if the product mix has not changed materially, this ratio measures whether or not a company's loss reserves are keeping pace with premium growth.

### **Quality and Diversification of Assets**

The quality and diversification of assets contributes to a company's financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) are



evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The better the liquidity, diversification and/or quality of the assets, the less uncertainty there is in the value to be realized upon their sale and the lesser the likelihood of default. Therefore, a review of a company's invested assets is performed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large single investments that exceed 10% of a company's total capital. Companies that hold illiquid, undiversified and/or speculative assets and have a significant underwriting exposure to volatile lines of business that are vulnerable to unfavorable changes in underwriting and/or economic conditions can jeopardize policyholders' surplus.

## **Liquidity**

Liquidity measures a company's ability to meet its anticipated short- and long-term obligations to policyholders and other creditors. A company's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diversified and liquid or through operating cash flow. A high degree of liquidity enables an insurer to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

To measure a company's ability to satisfy its financial obligations without having to resort to selling long-term investments or affiliated assets, we review a company's quick liquidity, which measures the amount of cash and quickly convertible investments that have a low exposure to fluctuations in market value. We also review current liquidity to measure the proportion of a company's total liabilities that are covered by cash and unaffiliated invested assets. Operational and net cash flows are reviewed since they, by themselves, can meet some liquidity needs provided cash flows are positive, large and stable relative to cash requirements. Finally, we evaluate the quality, market value and diversification of assets, particularly the exposure of large single investments relative to capital.

In order to measure a life insurer's potential vulnerability to all surrenderable liabilities, it is necessary to review the impact of asset and liability maturations under normal and stressed cycles in the event of a crisis of confidence. A loss of confidence in the financial strength of an insurer on the part of distributors or policyholders, which can lead to a "run on the bank", can be triggered by adverse changes in the company's financial strength, the economy, the financial markets and/or a company's media profile.

The immediate liquidity analysis begins with an assessment of a life insurer's liability structure and the withdrawal characteristics of its policies and contracts.

Companies that maintain a significant concentration of immediately surrenderable liabilities, which may be subject to unexpected calls on their assets, require greater levels of short-term liquidity. As a result, an evaluation is made to determine how vulnerable a company is to a potential "run" and its ability to satisfy its obligations to policyholders in the event a "run" is triggered. Included in our review is the size of the contracts issued, applicable surrender charges or market value adjustments, withdrawal restrictions, the types of distribution systems utilized, financial incentives which may exist for the replacement of policies, the level of highly liquid assets maintained, the strength and trends of cash flows and individual company's media profiles.

## **Key Liquidity Tests:**

- **Quick Liquidity:** This ratio measures the proportion of net liabilities covered by cash and investments that can be quickly converted to cash. This ratio may indicate a company's ability to settle its outstanding liabilities without prematurely selling long-term investments or to borrow money.
- **Current Liquidity:** This ratio measures the proportion of liabilities covered by unencumbered cash and unaffiliated investments. If this ratio is less than 100, the company's solvency is dependent on the collectibility of premium and reinsurance balances and the marketability of investments in affiliates.
- **Overall Liquidity:** This ratio indicates a company's ability to cover net liabilities with total assets. This ratio does not address the quality and marketability of premium balances, other receivables, affiliated investments and other assets.
- **Operating Cash Flow:** This test measures a company's ability to meet current obligations through the internal generation of funds from insurance operations. Negative balances may indicate unprofitable underwriting results or low yielding assets.
- **Non-Investment Grade Bonds to Capital:** This test measures exposure to non-investment grade bonds as a percentage of capital & surplus. Generally, non-investment grade bonds carry higher default and illiquidity risks.
- **Mortgages & Credit Tenant Loans & Real Estate to Capital:** Mortgage loans and credit tenant loans and real estate (home office property, property held for income and property held for sale) as a percentage of capital and surplus funds (including AVR).
- **Affiliated Investments to Capital:** Affiliated investments (including home office property) as a percentage of capital and surplus funds (including AVR).



## SECTION VIII

### OPERATING PERFORMANCE

#### Profitability

Profitable insurance operations are essential for a company to operate as an ongoing concern. For an insurer to remain viable in the marketplace, it must perpetuate a financially strong balance sheet for its policyholders. When evaluating operating performance, Best's analysis centers on the stability and sustainability of the company's sources of earnings in relation to the liabilities that are retained by the company. Since long term balance sheet strength is generally driven by operating performance, greater importance is placed on operating performance when evaluating insurers writing long tail business. Conversely, operating performance is weighted less heavily for those insurers writing predominately short tail business that also possess very strong capitalization and a stable business profile. A.M. Best reviews the components of a company's earnings over the past five-year period to make an evaluation of the sources of profits and the degree and trends of various profitability measures. Areas reviewed include underwriting, investments, capital gains/losses and total operating earnings, both before and after taxes. Profitability measures are easily distorted by operational changes. Therefore, we review the mix and trends of premium volume, investment income, net income and surplus. Also important to evaluating profitability is the structure of the company, (stock vs. mutual), the length and nature of its insurance liability risks and how these elements relate to the company's operating mission. The degree of volatility in a company's earnings and the impact that this could have on capitalization and balance sheet strength is of particular interest to A.M. Best.

To supplement our review of profitability, A.M. Best analyzes the company's earnings on a GAAP basis, IAS basis, and any other regulatory or accounting reporting in order to understand the company's forms and measurements of profitability. This review generally extends beyond the scope of publicly traded companies, since an increasing number of non-public insurers also prepare, monitor and/or manage to GAAP, IAS or other forms of accounting reporting. Best recognizes that a proper assessment of an insurer's current and prospective profitability may involve a review of multiple accounting forms and results.

#### Key Profitability Tests:

- **Loss Ratio:** This ratio measures the company's underlying profitability, or loss experience, on its total book of business.
- **Expense Ratio:** This ratio measures the company's operational efficiency in underwriting its book of business.
- **Combined Ratio after Policyholder Dividends:** This ratio measures the company's overall underwriting prof-

itability. A combined ratio of less than 100 indicates the company has reported an underwriting profit.

- **Operating Ratio:** The operating ratio measures a company's overall pre-tax operational profitability from underwriting and investment activities. An operating ratio of less than 100 indicates a company is able to generate a profit from its core operations.
- **Pretax ROR (Return on Revenue):** This ratio measures a company's operating profitability and is calculated as pre-tax operating income divided by net premiums earned.
- **Yield on Invested Assets:** This ratio measures the average return on a company's invested assets before capital gains/losses and income taxes.
- **Change in Capital & Surplus:** This ratio measures the annual change in a company's policyholders' surplus derived from operating earnings, investment gains, net contributed capital and other miscellaneous sources.
- **Return on Capital & Surplus:** This ratio measures a company's efficiency in utilizing its surplus on a total return basis. "Total return" is calculated as the overall after-tax profitability from underwriting and investment activity, including unrealized capital gains.

#### Key Profitability Tests for Life Companies:

- **Benefits Paid to NPW and Deposits:** Total benefits paid as a percentage of net premiums written and deposits. Benefits paid include death benefits, matured endowments, annuity benefits, accident and health benefits, disability and surrender benefits, group conversions, coupons and payments on supplementary contracts, interest on policy or contract funds and other miscellaneous benefits.
- **Commissions and Expenses to NPW and Deposits:** Commissions and expenses incurred as a percentage of net premiums written and deposits. Commissions and expenses include payments on both direct and assumed business, general insurance expenses, insurance taxes, licenses and fees, increase in loading and other miscellaneous expenses, and exclude commissions and expense allowances received on reinsurance ceded.
- **NOG to Total Assets:** Net operating gain (after taxes) as a percentage of the mean of current and prior year admitted assets. This test measures insurance earnings in relation to the company's total asset base.
- **NOG to Total Revenue:** Net operating gain (after taxes) as a percentage of total revenues. This test measures insurance earnings in relation to total funds provided from operations.
- **Operating Return on Equity:** Net operating gain (after taxes) as a percentage of the mean of current and



prior year capital and surplus. This test measures insurance earnings in relation to the company's policyholders' surplus base.

• **Net Yield:** Net investment income expressed as a percent of mean cash and invested assets plus accrued investment income minus borrowed money. This test does not reflect realized and unrealized capital gains or income taxes.

• **Total Return:** The net yield plus realized and unrealized capital gains and losses, minus transfers to IMR, plus amortization of IMR.

## SECTION IX

### BUSINESS PROFILE

#### Business Profile Issues

Business profile can be an important component of Best's rating evaluation. The factors that comprise an insurer's business profile drive current and future operating performance and, in turn, can impact long-term financial strength and the company's ability to meet its obligations to policyholders.

Business profile is influenced by the degree of risk inherent in the company's mix of business, an insurer's competitive market position, and the depth and experience of its management. Lack of size or growth are not considered negative rating factors unless A.M. Best believes these issues have a negative influence on the company's prospective operating performance and balance sheet strength.

A.M. Best places greater emphasis on business profile issues for insurers writing long-duration business, such as life, retirement savings, casualty lines, and reinsurance where long term financial strength is critical. Conversely, less business profile emphasis is placed on auto and property writers as well as indemnity health insurers writing shorter duration contracts where short-to medium-term financial strength is of greater importance.

In addition, business profile issues increase in their importance at Best's highest rating levels. At the "Superior" level, insurers are expected to have strong balance sheets and adequate operating performance, and exhibit stable operating trends. What differentiates these companies is the strength of their business profile, which typically translates into defensible competitive advantages. This rating approach is consistent with the requirements of today's marketplace, which is concerned with an insurer's financial strength and market viability.

#### Key Business Profile Issues:

**Spread of Risk:** A company's book of business must be analyzed by line in terms of its geographic, product and distribution diversification. However, the size of a compa-

ny, measured solely by its premium volume, cannot be used to judge its spread of risk.

Generally, large companies have a natural spread of risk. Similarly, a small company, which is conservatively managed, writes conservative lines of business and avoids a concentration of risk, can attain the same degree of stability in its book of business as that experienced by a large company, with the exception of regulatory or residual market risks.

For property/casualty companies, the geographic location and concentration of a book of business can have a great impact upon its exposure to catastrophic losses, such as terrorist attacks, hurricanes, tornadoes, wind storms, hail or earthquakes. For property insurers, Best requires a company to perform some degree of natural catastrophe modeling on its book of business.

Property insurers with potential exposures that have never performed weather and earthquake-catastrophe modeling are effectively required to do so in order to qualify for Best's Secure ratings (A++ to B+). Best's believes that natural catastrophe modeling is critical and plays an important role in prudently managing underwriting exposures. Best's gathers catastrophe exposure and related reinsurance protection data through our Supplemental Rating Questionnaire.

For life/health companies, the mix of business must be evaluated with respect to the distribution and performance of the underlying assets, as well as a company's susceptibility to economic business cycles or regulatory pressures, such as minimum loss ratios, market conduct regulation or financial services and health care reform initiatives.

The geographic location and lines of business written by a company also determine its exposure or vulnerability to regulatory or residual market risks that exist within certain jurisdictions. In addition, the mix of business must also be carefully evaluated. Because the underwriting experience between lines of business varies dramatically, the underwriting risk profile of a company must be determined since high-risk lines with volatile loss experience can impact the financial stability of an insurer, particularly one that is poorly capitalized and/or has poor liquidity.

**Revenue Composition:** A by-line analysis of net premium volume is important to determine changes in the amount, type, geographic distribution, diversification and volatility of business written by a company, which can either have a beneficial or adverse effect on a company's prospective profitability. Underwriting income, investment income, capital gains, asset values and, consequently, surplus can be significantly affected by external changes in economic, regulatory, legal and financial market environments, as well as by natural and man-made catastrophes.

**Competitive Market Position:** Analysis of an insurer's operating strategy and competitive advantages by line is essential to assess a company's ability to respond to competitive market challenges, economic volatility and regulatory change in relation to its book of business. Defensible and sustainable competitive advantages include; control



over distribution, multiple distribution channels, a low cost structure, effective utilization and leveraging of technology, superior service, strong franchise recognition, a captive market of insureds, easy and inexpensive access to capital, and underwriting expertise within the book of business.

**Management:** The experience and depth of management are important determinants for achieving success. Because the insurance business is based on an underlying foundation of trust and fiscal responsibility, prudent management plays a more vital role than in most other industries.

Competitive pressures within virtually every insurance market segment have amplified the importance of management's ability to develop and execute defensible strategic plans. Best's understanding of the operating objectives of a company's management team play an important role in our qualitative evaluation of the current and future operating performance of a company. This is particularly true when a company is undergoing restructuring to address operational issues, balance sheet problems or is actively raising capital.

**Insurance Market Risk:** Insurance market risk reflects the potential financial volatility that is introduced by, and associated with, the segment(s) of the insurance industry and/or the financial services sectors within which an organization operates. Such risks may also be considered systemic risks and are generally common to all market participants (i.e., financial services reform, healthcare reform, expansion of alternative markets, and integration of healthcare providers). Insurance market risk can be biased either positively or negatively by a number of company-specific business factors.

**Event Risk:** Event risk can encompass a variety of sudden or unexpected circumstances that may arise and can potentially impact an insurer's financial strength and its Best's Rating. When a sudden or unexpected event occurs, we evaluate the financial and market impact to the insurer. For example, the potential exists for major business and distribution disruption associated with significant litigation, the potential for a "run-on-the-bank" due to a loss of policyholder/distributor confidence, economic collapse or the enactment of significant legislation. In addition, constraints imposed by regulators in the form of mandated rate rollbacks, extraordinary assessments, and mandatory market lock-in arrangements in catastrophe-prone areas can adversely affect a company. Event risk may include changes in management, ownership, parental commitment, distribution, a legal ruling or regulatory development. Finally, event risks can also be influenced by potential regulatory or legislative reforms, economic conditions, interest rate levels, and financial market performance, as well as societal changes. For international companies, and domestic insurers operating abroad, political climates and sovereignty risks may also have a significant bearing on event risk.

## SECTION X

### AFFILIATION CODES AND RATING MODIFIERS

Affiliation Codes and Rating Modifiers are added to Best's Financial Strength Ratings to identify companies whose assigned rating is based on a Group (g), Pooling (p), or Reinsurance (r) affiliation with other insurers. In addition, a company's rating may be placed Under Review and be subject to a near-term change, as indicated by the "u" rating modifier. A Best's Rating may carry a "pd" rating modifier, indicating that the company did not subscribe to our interactive rating process. The "pd" modifier is assigned to companies based upon a review of publicly available financial data. The "s" rating modifier is assigned to syndicates operating at Lloyd's that have subscribed to our interactive rating process. These affiliation codes or modifiers appear as a lower-case suffix to the rating (e.g. A g, A u, A pd, etc.).

Insurers with affiliation codes (g, p, r) indicate that their rating is based on the consolidated performance of the company and its affiliation with one or more insurers, which collectively operate, in Best's opinion, as one coordinated insurance group and meets our criteria for the same rating. Accordingly, the Financial Size Category (see Section XII) of these member companies usually equals that of the group.

#### Affiliation Codes

**"g" Group Rating:** Assigned to the parent company of a group and is based on the consolidation of the parent company and its insurance subsidiaries where ownership or board control exceeds 50%.

The group rating is also assigned to certain subsidiaries based on the consolidation of the subsidiary and the parent. To qualify for full rating uplift, a subsidiary must be deemed integral to the group's business strategy, generally operates under common management and/or ownership, and serves as a strategic marketing or distribution arm of its parent. A stand-alone analysis is conducted on all insurance subsidiaries and comparable stand-alone operating performance and capitalization is expected to qualify for full rating uplift. In certain cases, group ratings are also assigned to sister companies owned by a common holding company.

**"p" Pooled Rating:** Assigned to members of an intercompany pool that effectively pool all their net business. The pooled rating is based on the consolidation of pool members and their subsidiaries. To qualify, a pool member must operate under common management and/or ownership (or substantial board control for mutual insurers) serve as a strategic affiliate to the group, and prorate all current and prior premiums, expenses and losses among the pool members in accordance with specified percentages that are comparable to the distribution of the policyholders' surplus



of each member of the group. Other important features to the contract are the notice of termination and the treatment of run-off liabilities after termination.

Typically, all pool members are assigned the same rating and Financial Size Category, based on their consolidation. NOTE: Some of these pooling arrangements do not include joint and several liability clauses between the company members, but other clauses may be included to help to protect the rights to collect from other pool members.

**"r" Reinsured Rating:** Assigned to a company within a group that reinsures substantially all direct premiums written with an affiliated reinsurer. The rating is based on the consolidation of the company's reinsurer and its subsidiaries. To qualify, a company must operate under common management and/or ownership as its reinsurer. Other important features to the contract are the coverage of prior liabilities, notice of termination and the treatment of run-off liabilities after termination. Typically, reinsured affiliates are assigned the same rating and Financial Size Category as their reinsurer.

### **Rating Modifiers**

**"u" Under Review:** Assigned to companies whose rating is currently under review due to a recent event or abrupt change in its financial condition, which may have positive, developing, or negative rating implications. A rating placed under review with positive implications indicates that, based on information currently available, the rating will either be affirmed or upgraded once A.M. Best completes its assessment and removes the under review modifier. Conversely, a rating placed under review with negative implications indicates that, based on information currently available, the rating will either be affirmed or downgraded once A.M. Best completes its assessment and removes the under review modifier. A rating placed under review with developing implications indicates that, based on information currently available, it is unclear how the recent event or abrupt change in financial condition will impact the rating.

A company's rating remains under review until A.M. Best is able to fully review the rating implications of the event before either affirming, upgrading or downgrading the rating. Generally, a company's rating is placed Under Review for less than six months.

**"pd" Public Data Rating:** Assigned to Canadian, UK and other European insurers, and HMOs and health insurers (United States) that do not subscribe to our interactive rating process. Best's Public Data Ratings reflect both qualitative and quantitative analysis using publicly available data and other public information. Public Data Ratings will be assigned where in Best's opinion ratings are needed due to market demand. To maintain analytical integrity Public Data Ratings may be assigned to affiliated companies that do not voluntarily subscribe to a full interactive rating process.

**"s" Syndicate Rating:** Assigned to syndicates operating at Lloyd's that meet our minimum size and operating experience requirements for a Best's Rating and subscribe to our interactive rating process.

## SECTION XI

### **"NOT RATED" (NR) CATEGORIES**

For non-rated (NR) companies, a condition exists that makes it difficult for A.M. Best to develop an opinion on the company's balance sheet strength and operating performance. Generally, these companies do not qualify for a Best's Rating because of their limited financial information, small level of surplus, lack of sufficient operating experience, or due to their dormant or run-off status.

Unrated companies are assigned to one of five "Not Rated" (NR) categories.

#### **NR-1 (Insufficient Data)**

Assigned predominately to small companies for which A.M. Best does not have sufficient financial information required to assign rating opinions. The information contained in these limited reports is obtained from several sources, which include the individual companies, and other data providers

#### **NR-2 (Insufficient Size and/or Operating Experience)**

Assigned to companies that do not meet A.M. Best's minimum size and/or operating experience requirements. To be eligible for a letter rating, a company must generally have a minimum of USD 2 million in policyholders' surplus to assure reasonable financial stability and have sufficient operating experience to adequately evaluate its financial performance, usually two to five years. General exceptions to these requirements include: companies that have financial or strategic affiliations with Best's rated companies; companies that have demonstrated long histories of financial performance; companies that have achieved significant market positions; and newly formed companies with experienced management that have acquired seasoned books of business and/or developed credible business plans.

#### **NR-3 (Rating Procedure Inapplicable)**

Assigned to companies that are not rated by A.M. Best, because our normal rating procedures do not apply due to a company's unique or unusual business features. This category includes companies that are in run-off with no active business writings, are effectively dormant, or underwrite financial or mortgage guaranty insurance. Exceptions to the assignment of the NR-3 designation include run-off companies that commenced run-off plans in the current year or inactive companies that have been structurally separated from active affiliates within group structures that pose potential credit, legal or market risks to the group's active companies.



#### NR-4 (Company Request)

Assigned to companies that are assigned a Best's rating following a review of their financial performance, but request that the assigned letter rating not be published on their company. The NR-4 is assigned following the publication of a final letter rating opinion.

#### NR-5 (Not Formally Followed)

Assigned to insurers that are not formally evaluated for the purposes of assigning a rating opinion. It is also assigned retroactively to the rating history of traditional U.S. insurers when they provide prior year(s) financial information to A.M. Best and receive a Best's Rating or another NR designation in more recent years. Finally, it is assigned currently to those companies that historically had been rated, but no longer provide financial information to A.M. Best because they have been liquidated, dissolved, or merged out of existence.

## SECTION XII FINANCIAL SIZE CATEGORIES (FSC)

A.M. Best assigns a Financial Size Category (FSC) to each letter rated company. The FSC is designed to provide the subscriber with a convenient indicator of the size of a company in terms of its most recent cross-checked submission of year-end, first, second or third quarter statutory surplus and related accounts. Many insurance buyers consider buying insurance coverage from companies that they believe have the sufficient financial capacity to provide the necessary policy limits to insure their risks.

Best's Financial Size Category is based on reported policyholders' surplus plus conditional or technical reserve funds, such as other investment and operating contingency funds, and miscellaneous voluntary reserves reported as liabilities.

The FSC is represented by Roman numerals ranging from Class I (the smallest) to Class XV (the largest).

#### FINANCIAL SIZE CATEGORY

Financial Size Category	Adjusted Capital and Surplus (US \$ thousands)		
Class I	Up	to	1,000
Class II	1,000	to	2,000
Class III	2,000	to	5,000
Class IV	5,000	to	10,000
Class V	10,000	to	25,000
Class VI	25,000	to	50,000
Class VII	50,000	to	100,000
Class VIII	100,000	to	250,000
Class IX	250,000	to	500,000
Class X	500,000	to	750,000
Class XI	750,000	to	1,000,000
Class XII	1,000,000	to	1,250,000
Class XIII	1,250,000	to	1,500,000
Class XIV	1,500,000	to	2,000,000
Class XV	2,000,000	or	greater

## SECTION XIII DEFINITIONS

### Organization Types

• **Stock Companies:** Stock companies are corporations, the financial ownership of which is comprised of capital stock that is divided into shares. Ultimate control of stock insurance companies is vested in the shareholders.

• **Mutual Companies:** Mutual companies are corporations without capital stock. Ultimate control of mutual insurance companies is vested in the policyholders.

• **Composites:** In certain countries stock or mutual companies may be authorized to operate in both property/casualty and life/health insurance. Financial reports on these organizations aggregate both types of insurance operations rendering analysis difficult since these businesses have dissimilar characteristics.

• **Cooperatives:** May include mutual-type structures with the possibility of limited individual ownership by insured cooperative members or even non-members.

• **Risk Retention Groups (RRG):** These entities, formed under the federal Liability Risk Retention Act of 1986 of the United States, enable businesses or professionals with similar risks to band together to provide needed liability coverages for each other. Under statute, RRGs are precluded from writing certain coverages, most notably property lines and workers' compensation. RRGs predominantly write medical malpractice, general liability, professional liability, and product liability excess liability coverages. A RRG can be formed as a mutual or stock company or a reciprocal.