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# PREFACE

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2009 EDITION

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

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### SECTION I

#### INTRODUCTION

Founded in 1899, A.M. Best Company is a global, full-service credit rating agency dedicated to serving the financial and health care service industries. It began assigning credit ratings in 1906, making it the first of today's credit rating agencies to use symbols to differentiate the relative creditworthiness of companies. Within the insurance segment, Best's Credit Ratings cover property/casualty, life, annuity, health, health maintenance organizations (HMOs), reinsurance, captive, and title insurance companies. A.M. Best provides the most comprehensive insurance ratings coverage of any credit rating agency, with reports and ratings maintained on over 10,000 insurance entities worldwide, in approximately 95 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'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 Credit Ratings and related financial information provide powerful tools for insurance decision-making and market research for insurance agents, brokers, risk managers, pension managers, employee benefits administrators, investment bankers, 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 published in 1906 reporting on 95 legal reserve life insurers in the United States. For more than a century, these two annual publications have represented the most comprehensive source of financial information on domestic insurers.

The 2009 Property/Casualty and Life/Health Editions of *Best's Insurance Reports®—United States & Canada* contain approximately 3,300 and 1,850 insurance companies, respectively. A.M. Best rates or reports on virtually all U.S. and Canadian active insurers and a growing number of Caribbean insurers. In addition, the 2009 editions contain Canadian property/casualty, Canadian life, Caribbean life and Caribbean property/casualty insurers and reports on United States, European, and Canadian branches.

In 1984, A.M. Best embarked on 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 5,800 international property/casualty and life/health companies.



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In 1999, A.M. Best expanded its rating assignments to include debt and insurance-linked securities. The issuance of securities ratings for insurers and insurance holding companies is a natural extension of our expertise in providing financial strength ratings and reports on insurance organizations to investors, analysts and policyholders. 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, A.M. Best now assigns 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, 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 engineer's 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.

## 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, territory 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. The Canadian company presentations are in the format prescribed by the Office of the Superintendent of Financial Institutions (OSFI), and some portions of the Canadian data are provided by Beyond 20/20 Inc., Ottawa, Canada.

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 Financial Reporting Standards (IFRS) 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.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information. Any and all ratings, opinions and information contained herein are provided "as is," without any express or implied warranty. A rating may be changed, suspended or withdrawn at any time for any reason at the sole discretion of A.M. Best.

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 CREDIT RATING SYSTEM

#### Financial Strength Ratings

A Best's Financial Strength Rating (FSR) is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile.

The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance obligations. The ratings are not assigned to specific insurance policies or contracts and do not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

An important component of the evaluation process requires an interactive exchange of information with the



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insurance company's management. 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 Credit Rating. A.M. Best may assign Best's Public Data Ratings (noted by the "pd" modifier) to Canadian property/casualty insurers as well as to U.S. health maintenance organizations (HMOs) and health insurers 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.

Best's Public Data Ratings are Best's opinion of the financial strength of an insurer. Public Data Ratings are expressed using the same rating scale and definitions as Best's interactive ratings of long-term financial strength but have a "pd" rating modifier applied to ensure the user is aware of the more limited information basis for the rating. Similar to our interactive ratings, the assignment of Best's Public Data Ratings incorporates analysis of balance sheet strength, operating performance and business profile. However, the analysis does not involve interaction with company management.

A Public Data Rating model, utilizing regulatory data filed by an insurance company or HMO with its regulator, is the primary source for the quantitative analysis used in assigning Best's Public Data Ratings. The model evaluates the five most recent years of a company's financial performance. A.M. Best will not assign Public Data Ratings to companies with less than three years of data. Other public documents and disclosures may be used as part of the analytical process for assigning Public Data Ratings. The assessment also considers certain qualitative factors such as prevailing market trends and the current regulatory environment relevant to the business of the legal entity being rated.

#### Type of Rating Opinions

	<b>Best's Financial Strength Ratings</b>	
	<b>Interactive</b>	<b>Public Data</b>
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 rate of failure that 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 (ICR) and Debt Ratings to insurance operating companies and holding companies and securities issued by these entities. 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 Web site, [www.ambest.com](http://www.ambest.com).

A Best's Debt/Issuer Credit Rating is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, 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.

A Best's Long-Term Issuer Credit Rating is an opinion of an issuer/entity's ability 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 of an issuer/entity's ability to meet its senior financial obligations having original maturities of generally less than one year.

A Best's Long-Term Debt Rating is an independent opinion of an issuer/entity's ability to meet its ongoing financial obligations to security holders when due. This rating is assigned to specific issues such as debt and preferred stock.

A Best's Short-Term Debt Rating is an opinion of an issuer/entity's ability to meet its financial obligations having original maturities of generally less than one year. These ratings are assigned to securities such as commercial paper.

## SECTION IV

### **BEST'S CREDIT 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"



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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 insurance obligations.

**A and A- (Excellent)**  
Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.

**B++ and B+ (Good)**  
Assigned to companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.

### **Vulnerable**

**B and B- (Fair)**  
Assigned to companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations, 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 insurance obligations, 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 insurance obligations, but are financially very vulnerable to adverse changes in underwriting and economic conditions.

**D (Poor)**  
Assigned to companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations 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.

## **Best's 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)**  
Assigned to issues where, in our opinion, the issuer has an exceptional ability to meet the terms of the obligation.

**aa+ and aa and aa- (Very Strong)**  
Assigned to issues where, in our opinion, the issuer has a very strong ability to meet the terms of the obligation.

**a+ and a and a- (Strong)**  
Assigned to issues where, in our opinion, the issuer has a strong ability to meet the terms of the obligation.

**bbb+ and bbb and bbb- (Adequate)**  
Assigned to issues where, in our opinion, the issuer has an adequate ability to meet the terms of the obligation; however, the issue is more susceptible to changes in economic or other conditions.

### **Non-Investment Grade**

**bb+ and bb and bb- (Speculative)**  
Assigned to issues where, in our opinion, the issuer has speculative credit characteristics, generally due to a moderate margin of principal and interest payment protection and vulnerability to economic changes.

**b+ and b and b- (Very Speculative)**  
Assigned to issues where, in our opinion, the issuer has very speculative credit characteristics, generally due to a modest margin of principal and interest payment protection and extreme vulnerability to economic changes.





**ccc+** and **ccc** and **ccc-**  
and **cc** and **c**

**(Extremely Speculative)**

Assigned to issues where, in our opinion, the issuer has extremely speculative credit characteristics, generally due to a minimal margin of principal and interest payment protection and extreme vulnerability to economic changes.

**d**

**(In Default)**

Assigned to issues in default on payment of principal, interest or other terms and conditions, or when a bankruptcy petition or similar action has been filed.

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.

**Best's 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)**

Assigned to issues where, in our opinion, the issuer has the strongest ability to repay short-term debt obligations.

**AMB-1**

**(Outstanding)**

Assigned to issues where, in our opinion, the issuer has an outstanding ability to repay short-term debt obligations.

**AMB-2**

**(Satisfactory)**

Assigned to issues where, in our opinion, the issuer has a satisfactory ability to repay short-term debt obligations.

**AMB-3**

**(Adequate)**

Assigned to issues where, in our opinion, the issuer has an adequate ability to repay short-term debt obligations; however, adverse economic conditions will likely reduce the issuer's capacity to meet its financial commitments.

**Non-Investment Grade**

**AMB-4**

**(Speculative)**

Assigned to issues where, in our opinion, the issuer has speculative credit characteristics and is vulnerable to

adverse economic or other external changes, which could have a marked impact on the company's ability to meet its financial commitments.

**d**

**(In Default)**

Assigned to issues in default on payment of principal, interest or other terms and conditions, or when a bankruptcy petition or similar action has been filed.

With the growing interest by non-policyholders in insurers' creditworthiness, A.M. Best draws a distinction between the Financial Strength and Issuer Credit ratings. The FSR remains an opinion specific to the insurer's ability to meet ongoing insurance obligations, while the ICR is an opinion as to the overall creditworthiness of an insurer from the perspective of its senior creditors. This distinction is important when considering ratings other than an FSR within an insurance organization, since ratings both of an organization's debt issues and of related legal entities, such as holding companies, are tied to and based on the overall creditworthiness of the operating insurer.

## SECTION V

### **RELEASE OF FINANCIAL STRENGTH RATINGS**

Best's rating opinions are formally evaluated at least once every 12 months. The annual 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 SEC filings (if applicable), together with other publicly available financial statements prepared under GAAP or IFRS standards and confidential documents including Best's Supplemental Rating Questionnaires (for interactive Best's Credit Ratings).

With our interactive Best's Credit Ratings, analysts maintain rating contact with company management 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 management.

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 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 Credit Ratings are updated and are released as soon as practicable through *Best's Internet Service* via [www.ambest.com](http://www.ambest.com)—A.M.



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Best's Web site. Rating upgrades and downgrades, as well as initial ratings are also released through Best's Rating Actions in *BestWeek*<sup>®</sup>, 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>, our monthly magazine. Finally, updated *AMB Credit Reports - Insurance Professional (Unabridged)* are available shortly after the publication of a company's updated rating assignment and following the review of the company's annual statutory statement.

### **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. Rating outlooks can be positive, negative or stable. A positive outlook indicates that a company is experiencing favorable financial and market trends, relative to its current rating level. If these trends continue, the company has a good possibility of having its rating upgraded. A negative outlook indicates that a company is experiencing unfavorable financial and market trends, relative to its current rating level. If these trends continue, the company has a good possibility of having its rating downgraded. A stable outlook indicates that a company is experiencing stable financial and market trends, and that there is a low likelihood the company's rating will change over an intermediate period. Positive or negative outlooks do not necessarily lead to a change in a company's rating. Similarly, a stable rating outlook does not preclude a rating upgrade or downgrade. Rating outlooks appear immediately following the Rating Rationale section of the company's *AMB 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 CREDIT 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 method 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.

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 com-

pany'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 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-duration liabilities (less than 2-3 years) or those companies maintaining extremely strong balance sheet strength. Companies exposed to short-duration liabilities face fewer unknown losses, reducing long-term risk. Alternatively, those companies exposed to long-duration 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.

### **Risk Management**

An important aspect of any insurance company operation, risk management is the process by which companies systematically identify, measure and manage the various types of risk inherent within their operations. The fundamental objectives of a sound risk management program are to manage the organization's exposure to potential earnings and capital volatility, and maximize value to the organization's various stakeholders. Enterprise Risk Management (ERM) has grown in importance as companies 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.

Best believes that ERM encompasses a wide range of activities, from traditional risk management practices to the use of sophisticated tools to identify and quantify risks. One of the tools used to quantify risks, and measure the volatility and correlation of risks is an economic capital (EC) model. Best believes that a strong EC model—capturing and quantifying all the material risks and risk interdependencies of an organization—can be a valuable tool to an insurer, but it is just one of many tools and processes utilized within the overall risk management framework.



## **Group Ratings**

Regulatory requirements and market dynamics often require insurers to set up subsidiaries or branch offices in foreign countries. These overseas subsidiaries carry differing levels of importance and risk to their parent companies. Some are crucial to the success of the franchise, yet they may require significant investment before they turn a profit. For other insurers, the foreign operation may simply be an ancillary investment with a relatively short time horizon. These factors and others weigh heavily in A.M. Best's ratings of insurance companies that are members of a group. The need for international insurers to set up operations in numerous jurisdictions to maintain access to market intelligence has brought into focus the notion of fungibility of capital—that is, an organization's ability to allocate and deploy capital in the most efficient way where it is most needed. A.M. Best recognizes that to sustain a competitive advantage, these groups must allocate their capital with maximum efficiency. However, to obtain a Secure credit rating, a certain minimum level of capitalization must be maintained at the insurance company level.

A.M. Best evaluates insurance groups to determine what levels of rating enhancement or drag are placed on the individual ratings of members of insurance groups. One of the main themes is the implicit and explicit support a parent provides its insurance subsidiaries. These factors, together with any legal constraints on the free flow of capital among affiliates, will determine an insurance subsidiary's rating enhancement or drag and its ultimate rating assignment.

Rating members of complex, domestic or multinational insurance organizations is a difficult task. A.M. Best performs comprehensive quantitative and qualitative analyses of an organization's balance sheet strength, operating performance and business profile. Every legal entity that maintains an A.M. Best rating is reviewed on a stand-alone basis. The entity's strengths and weaknesses are analyzed, without any benefit or drag from its affiliation with a larger organization. Employing this approach allows A.M. Best to gauge the level of policyholder security with no benefit from parental support. Through this analysis, a stand-alone rating is determined for all entities except those that possess a pooled (p) or reinsured (r) rating modifier (see section X, Affiliation Codes and Rating Modifiers).

Recognizing that an insurer very often benefits greatly from its inclusion within a strong, diversified group, the published ratings of these entities often include some element of rating enhancement. This enhancement points to the insurer's greater ability to compete successfully, generate earnings and sustain a strong balance sheet over time through the support of its parent or affiliate companies. To determine this level of support, in addition to the stand-alone analysis, A.M. Best conducts a thorough, top-down evaluation of the organization's strength on a consolidated basis.

A.M. Best uses its consolidated view of the organization to conduct an enterprise-level analysis. This determines the highest possible rating for the lead insurer within the group, accounting for strengths and weaknesses that may reside not

only within the insurance entities but also at the holding company or at a non-insurance affiliate. With this information, A.M. Best determines whether or not the individual insurance subsidiaries qualify for enhancement or drag to their stand-alone ratings.

## **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 Credit 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 enhancement, partial rating enhancement or no rating enhancement.

- Subsidiaries that achieve full rating enhancement are critical to the group's strategy and ongoing success; fully integrated into the group's strategic plan; carry the group name or are easily identified with the group; are material to the business profile of the group; are significant contributors to the group's earnings; currently benefit from some form of explicit parental support and have a history of receiving explicit support when needed.
- Subsidiaries that achieve partial rating enhancement are important to the group's business strategy and profile; may operate on a more independent basis, through a separate identity or distribution platform; provide a source of diversification to the group's earnings; are meaningful contributors to the group's operating performance and/or financial strength; currently benefit from some form of explicit parental support and are highly likely to receive future support.
- Subsidiaries that receive no rating enhancement are marginal to the group's overall strategy; can be readily sold without material impact to the group's ongoing operations; have a separate operating platform; are managed independently with a separate marketing identity; lack business synergy with the parent's core operations; provide no meaningful diversification benefits; and are not a significant contributor to the group's earnings or capital.

## **Rating Start-up Insurers**

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, and capitalization. However, in addition to these factors, certain conditions must be present, transcend-



ing 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 prior to the initial rating assignment.
- Appropriate management, staff and operational infrastructure must be available to support initial activities.
- A follow-up process to review 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.
- Stress-tested capitalization must conservatively support the assigned rating throughout the business plan.

## SECTION VII

### BALANCE SHEET STRENGTH

In determining a company's ability to meet its current and ongoing senior obligations, 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 equity/surplus, but may be exposed to a high risk of instability. Conservative 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 a company's underwriting leverage is prudent, a number of factors unique to the company are taken into consideration. These factors include type 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 of financial leverage is conducted both at 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 an insurer's earnings and cash flow. In other words, the residual risk to the insurer would be insignificant as long as the insurer possesses sound asset/liability, liquidity and investment risk management capabilities; exhibits low duration mismatches; and minimizes repayment and liquidity risk relative to these obligations. Best has established specific tolerances for operating leverage activities that are applied at each operating company, as well as at the consolidated level. Generally, debt obligations viewed by A.M. Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

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. The BCAR is based on audited financial statements and supplemental information provided by companies. A company's BCAR result is useful in determining a company's balance sheet strength. A.M. Best also views insurance groups on a consolidated basis and assigns a common BCAR result to group consolidations or multiple member companies that are linked together through inter-company pooling or reinsurance arrangements.

A.M. Best recognizes that risk management tools and practices across the insurance industry have advanced significantly in recent years. Developments such as the implementation of ERM programs, including economic





capital models, more sophisticated catastrophe management, and dynamic hedging programs have headlined efforts of the insurance industry to manage its growing exposure to potential earnings and capital volatility.

Given the insurance industry's evolving risk profile and the significant recent advancements made in the risk management tools and practices, Best recognizes that a more economic, prospective view of capital can be another valuable supplement to the rating process. As a result, Best is expanding the review of company-provided EC models in our development of capital requirements within the rating evaluation process. Best will consider using the output of company-provided models for analytical purposes; however, the BCAR will still be published as a common industry-wide baseline for capital adequacy.

#### CAPITALIZATION TESTS FOR LIFE COMPANIES

- **Change in Net Premiums Written (NPW) and Deposits:** The annual percentage change in net premiums written and deposits. This test is a measure of growth in underwriting commitments.

- **NPW and Deposits to Total Capital:** Net premiums written and deposits related to capital and surplus funds, including asset valuation reserve (AVR). This reflects the leverage, after reinsurance assumed and ceded, of the company's current volume of net business in relation to its capital and surplus. This test measures the company's exposure to pricing errors in its current book of business.

- **Capital & Surplus to Liabilities:** The ratio of capital and surplus (including AVR) to total liabilities (excluding AVR). This test measures the relationship of capital and surplus to the company's unpaid obligations after reinsurance assumed and ceded. It reflects the extent to which the company has leveraged its capital and surplus base. On an individual company basis, this ratio will vary due to differences in product mix, balance sheet quality and spread of insurance risk.

- **Surplus Relief:** The relationship of commissions and expense allowances on reinsurance ceded to capital and surplus funds. The use of surplus relief can be the result of "surplus strain," a term used to describe any insurance transaction wherein the funds collected are not sufficient under regulatory accounting guidelines to cover the liabilities established.

- **Reinsurance Leverage:** The relationship of total reserves ceded plus commissions and expenses due on reinsurance ceded plus experience rating and other refunds due from reinsurers, plus amounts recoverable from reinsurers to total capital and surplus.

- **Change in Capital:** The annual percentage change in the sum of current year capital and surplus, plus AVR, plus voluntary investment reserves, over the prior year's sum.

- **Best's Capital Adequacy Ratio (BCAR):** The BCAR 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 Credit Rating. However, 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 is calculated as the necessary level of capital to support four broad risk categories, including C1 (Asset Risk); C2 (Underwriting Risk); C3 (Interest Rate Risk); and C4 (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 risks associated with many of the four categories are independent and do not occur at the same time.

Generally, over two-thirds of a life insurance company's net capital requirement is generated by C1 (Asset Risk) and C3 (Interest Rate Risk). Conversely, over two-thirds of a health company's net capital requirement is generated by its C1 (Asset Risk) and C2 (Underwriting Risk). The Underwriting Risk components are influenced by a company's business profile which includes distribution of premium by line and size.

#### CAPITALIZATION TESTS FOR HEALTH COMPANIES

- **Liabilities to Assets:** The ratio of total liabilities to total assets. This test measures the proportion of liabilities covered by a company's asset base.

- **Net Premiums Written to Capital:** The ratio of premiums to total capital and surplus. This test measures the leverage associated with the level of premiums compared to the total capital and surplus of the company. The higher the number, the more leveraged the company.

- **Debt to Capital & Surplus:** The ratio of a company's total debt to its total capital and surplus. In this ratio, debt is defined as loans and notes payable on both a current and long-term basis, as well as surplus notes.

- **Equity PMPM:** The ratio of capital and surplus to member months. This test measures the amount of capital and surplus spread over a company's membership base.



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• **Capital & Surplus to Total Assets:** The ratio of total capital and surplus to total assets. This test measures the relationship of a company's asset base to its capital and surplus.

• **Months Reserves:** The ratio of a company's total capital and surplus to monthly average total expenses. This test provides a measure of the duration of a particular company's capital and surplus versus its expense commitments.

• **Best's Capital Adequacy Ratio (BCAR):** See Above

### **Capital Structure/Holding Company**

Holding companies (if present) and their associated capital structures can have a significant impact on the overall 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 a subsidiary.

A.M. Best reviews both an insurer's capital structure and its holding company's capital structure to determine if they are 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 rate, 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 that 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 and Other Risk Mitigation Programs**

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 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 wind storm, 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.

Another method of mitigating catastrophe risk is through the issuance of a catastrophe bond, which is a structured debt instrument that transfers risks associated with low-frequency/high-severity events to investors. These instruments typically incorporate either an indemnity trigger (based on an issuing company's actual loss experience), or some form of an index-based, parametric trigger (based on a pre-defined industry index). A.M. Best recognizes that parametric catastrophe bonds come with "basis risk" that must be considered in the Financial Strength Ratings (FSRs) of the companies sponsoring the bond issues. Basis risk, in the context of catastrophe bonds, generally reflects the possibility that a catastrophe bond may not be partially or fully triggered (for covered perils) even when the sponsor of the catastrophe bond has suffered a loss. Through A.M. Best's analysis a determination is made as to how much basis risk is inherent in a catastrophe bond, which determines how much reinsurance credit will be given to the insurance/reinsurance company that sponsors a catastrophe bond with a parametric trigger.

Sidecars are yet another way for insurers/reinsurers to mitigate risk. A sidecar is a limited-life, special-purpose reinsurance vehicle that generally provides property catastrophe quota-share reinsurance exclusively to its sponsor. Sponsors of sidecars generally take reinsurance credit for transferring risks to sidecars. While some sidecars may be capitalized to full aggregate limits, others may not be adequately capitalized to absorb losses that deviate from expectations. When capitalization is inadequate, some of the risk originally assumed to be fully hedged by a sidecar



(in the determination of the Best's FSR of the sponsor) ultimately may be borne by the sponsor. This risk is referred to as "tail risk." A.M. Best's analysts will assess tail risk to ensure that the appropriate reinsurance credit is given to the sponsor of a sidecar.

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 a counterparty's future growth prospects and long-term viability. Therefore, the range of reinsurance business 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 coverage for claims. It also can 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.

Over the past several years, direct life/health writers have been searching for other cost-effective capital solutions to fund reserves and/or transfer risk on a variety of products, including certain term and universal life products that are subject to reserve requirements of the Valuation of Life Insurance Policies Model Regulation, more commonly referred to as Regulation XXX. A number of life/health companies have developed capital markets solutions through a securitized transaction utilizing a captive company. These securitizations are typically intended to fund the difference between the statutory reserve and the economic reserve required to support the business according to the direct writer's own analysis.

These transactions impact a company's financial strength as measured by the BCAR calculation, and also impact a company's operating leverage. By ceding reserves to a captive company, the direct insurer's insurance risk is reduced on the BCAR. However, the captive is typically more thinly capitalized than the direct writer for these reserves (though within regulatory guidelines), and the capital structure is typically supported primarily through surplus notes, not equity contribution. Additionally, the

transfer of the reserves from the direct writer's balance sheet reduces surplus strain, freeing the company to write even more business. These various factors are considered in evaluating the appropriateness of the insurer's overall reinsurance and risk mitigation program.

### **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.

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 in a company's reported profitability, leverage, capitalization, and liquidity declines.

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

The quality and diversification of assets contribute 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 higher the liquidity, diversification and/or quality of the asset portfolio, the less uncertainty there is in the value to be realized upon an asset sale and the lesser the likelihood of default. Therefore, a company's investment portfolio and investment guidelines are reviewed 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 an individual company's media profile.

A.M. Best's review of liquidity for U.S. life companies utilizes A.M. Best's Liquidity Model for U.S. Life Insurers. Using statutory data, the model quantitatively measures a company's short-term (30 days) and longer-term (six to twelve months) cash needs positions under stressed scenarios. The model allows for conservative, standardized comparisons to be calculated and determines whether a company's calculated liquidity is within the range of its peers relative to its size, type of business and A.M. Best rating. A.M. Best's initial analysis has focused on companies with a preponderance of interest-sensitive liabilities.

#### KEY LIQUIDITY TESTS FOR LIFE COMPANIES

- **Quick Liquidity:** The ratio of unaffiliated quick assets to liabilities. Quick assets include cash and short-term

investments and a percentage of unaffiliated common stocks and unaffiliated public investment grade bonds. This test measures the proportion of liabilities (excluding AVR, conditional reserves and separate accounts) covered by cash and quickly convertible investments. It indicates a company's ability to meet its maturing obligations without requiring the sale of long-term investments or the borrowing of money.

- **Current Liquidity:** The ratio of total current assets to total liabilities. This test measures the proportion of liabilities (excluding AVR, conditional reserves and separate account liabilities) covered by cash and unaffiliated holdings, excluding mortgages and real estate.

- **Non-Investment Grade Bonds to Capital:** The sum of NAIC Classes three, four, five, and six bonds as a percentage of capital and surplus funds (including AVR).

- **Delinquent & Foreclosed Mortgages to Capital:** The sum of long-term mortgages upon which interest is overdue more than three months, in process of foreclosure and foreclosed real estate as a percentage of capital and surplus funds (including AVR).

- **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).

#### KEY LIQUIDITY TESTS FOR HEALTH COMPANIES

- **Current Liquidity:** The ratio of total current assets to total liabilities. This test measures the proportion of liabilities (excluding AVR, conditional reserves and separate account liabilities) covered by cash and unaffiliated holdings, excluding mortgages and real estate.

- **Overall Liquidity:** This ratio measures the proportion of total liabilities covered by a company's total assets, to reflect a company's ability to meet its maturing obligations.

- **Premium Receivable Turnover:** The ratio of premium receivables to commercial revenue. This ratio is expressed in months and measures the liquidity level of a company's total premium and fee-for-service revenue in light of its premium receivables for a specific period.

- **Cash and Assets to Claims & Payables:** The ratio of total cash, short-term investments and long-term investments to the sum of accounts payable and claims payable.



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- **Claims to Net Premium Earned:** The ratio of total claims payable to net premiums earned.

- **Health Average Claims Payment Period (days):** The ratio of claims payable to total health expenses per year in days (365).

- **Total Health IBNR Pay Period (days):** The ratio of total incurred but not reported claims divided by total health expenses in days (365).

## 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-duration business. Conversely, operating performance is weighted less heavily for those insurers writing predominantly short-duration business that also possess very strong capitalization and a stable business profile.

A.M. Best reviews the components of a company's statutory earnings over the past five-year period to make an evaluation of the sources of profits and the degree and trend 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, IFRS 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, IFRS 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 to ascertain the true economic picture.

#### 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 as a percentage 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 Interest Maintenance Reserve (IMR), plus amortization of IMR.

#### KEY PROFITABILITY TESTS FOR HEALTH COMPANIES

- **Benefits Paid to Net Premiums Written & Fee for Service:** Total medical and hospital or dental expenses as a percentage of net premiums written and fee for service. Also included with net premiums written and fee for service are risk revenues and changes in unearned premium reserves.

- **Commissions and Expenses to Net Premiums Written & Fee for Service:** Total claims adjustment expense and



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general administrative expenses as a percentage of net premiums written and fee for service. Also included with net premiums written and fee for service are risk revenues and changes in unearned premium reserves.

- **NOG to Total Assets:** Net income excluding net realized capital gains (losses) as a percentage of the average between prior year and current year assets. This test measures post-tax insurance earnings in relation to the mean of the company's current and prior year total admitted assets.

- **NOG to Revenue:** Net income excluding net realized capital gains (losses) as a percentage of total revenue. This ratio measures post-tax earnings in relationship to total funds provided from operations.

- **Operating Return on Equity:** Net income excluding net realized capital gains (losses) as a percentage of the average between prior year and current year capital and surplus. This test measures earnings in relation to the company's total capital and contingency reserve base.

- **Net Yield:** Net investment income as a percentage of the average between prior year and current year invested assets and accrued investment income less borrowed money. It does not reflect the impact of realized and unrealized capital gains or income taxes.

- **Total Return:** The net yield plus realized and unrealized capital gains and losses.

## 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 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 company, 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 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 its 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 com-



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petitive 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 plays an important role in its qualitative evaluation of the current and future operating performance of a company. This is particularly true when a company is undergoing a 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 sphere 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, health care reform, expansion of alternative markets, and integration of health care 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 Credit 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 risk 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), Pooled (p), or Reinsured (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 Financial Strength Rating may carry a "pd" rating modifier, indicating that the company did not subscribe to our interactive rating process. 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 lowercase suffix to the rating (i.e., 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 subsidiaries deemed to be integral to the group, which generally operate under common management and/or ownership. Group rated subsidiaries typically demonstrate a combination of the following characteristics. They are critical to the group's strategy and ongoing success; fully integrated into the group's strategic plan; carry the group name or are easily identified with the group; are material to the business profile of the group; are significant contributors to the group's earnings; currently benefit from some form of explicit parental support and have a history of receiving explicit support when needed. In certain cases, group ratings are also assigned to sister companies owned by a common holding company.

A stand-alone analysis is conducted on all insurance subsidiaries to assess each legal entity's stand-alone operating performance and capitalization, before consideration is given to any group rating enhancement.

**"p" Pooled Rating:** Assigned to a group whose member companies pool assets, liabilities and operating results and maintain, in theory, the same operating performance and



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balance sheet strength as other companies within the pool. Pooling is viewed as explicit financial support. The assets of each pool participant are available for the protection of all pool members' policyholders. In many cases, pooled affiliates market under a common brand name and generally operate under common management and/or ownership.

The pooled (p) affiliation code is typically assigned if the pooling agreement is joint and several; pure/net; stand-alone capitalization supports the assigned rating after the pool is considered; includes coverage for any prior year loss reserve development, and the run-off of all liabilities incurred on policies incepted prior to termination; ownership or board control exceeds 50% and includes a 12-month notice of termination.

**"r" Reinsured Rating:** Assigned to a company with 100% quota share of all gross premiums, losses and expenses (unless regulatory restrictions apply). Reinsurance is viewed as explicit financial support. In many cases, reinsured affiliates market under a common brand name and generally operate under common management and/or ownership.

The reinsured (r) affiliation code is typically assigned if stand-alone capitalization supports the assigned rating after the reinsurance is considered; the contract contains no loss caps or loss corridors; includes coverage for any prior year loss reserve development, and the run-off of all liabilities incurred on policies incepted prior to termination; ownership or board control exceeds 50% and includes a 12-month notice of termination.

### Rating Modifiers

**"u" Under Review:** Assigned to companies with potential near-term rating changes (typically within six months) due to a recent event or abrupt change in their 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, there is a reasonable likelihood the company's rating will be raised as a result of A.M. Best's analysis of the recent event. Conversely, a rating placed under review with negative implications indicates that, based on information currently available, there is a reasonable likelihood the company's rating will be lowered as a result of A.M. Best's analysis of the recent event. A rating placed under review with developing implications indicates that, based on information currently available, there is uncertainty as to the final rating outcome, but there is a reasonable likelihood the company's rating will change as a result of A.M. Best's analysis of the recent event.

A company's rating remains under review until A.M. Best is able to fully determine the rating implications of the event before 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 property/casualty 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 analyses using publicly available data and other public information. Public Data Ratings will be assigned where, in Best's view, ratings are needed due to market demand.

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

### RATING MODIFIER/AFFILIATION CODE DISTRIBUTION

Of the 1,164 individual total ratings assigned in Best's 2009 life/health publications, 614 or 53% were also assigned a Rating Modifier or Affiliation Code. Their distribution follows.

<u>RATING MODIFIER/ AFFILIATION CODE</u>	<u>NUMBER OF COMPANIES</u>
g - Group	453
p - Pooled	0
r - Reinsured	4
pd- Public Data	151
u - Under Review	<u>13</u>
<b>Subtotal</b>	<b>621</b>
Dual Assignment	<u>(7)</u>
<b>Total Modifier/ Affiliation Code Ratings</b>	<b>614</b>

## SECTION XI

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

The current universe of rated life/health companies account for roughly 95% of the premium volume in the United States. However, A.M. Best also reports on 694 life/health companies that are not assigned a rating opinion. Because of their small size, Not Rated (NR) insurers constitute only 5% of the industry's premium writings.

For Not 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 Credit 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.

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, the National Association of



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Insurance Commissioners (NAIC) and other data providers. Data received from the NAIC, in some cases, is prior to the completion of the cross-checking and validation process.

### **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 \$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-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 Credit 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 Credit 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.

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 regulatory 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 the asset valuation reserve (AVR), other investment and operating contingency funds and miscellaneous voluntary reserves reported as liabilities in U.S. dollars.

The FSC is represented by Roman numerals ranging from Class I (the smallest) to Class XV (the largest). The distribution by FSC based upon individual companies is shown below.

### **2009 FINANCIAL SIZE CATEGORY (FSC) BY INDIVIDUAL COMPANIES**

Financial Size Category	Adjusted Policyholders' Surplus (\$ Millions)	Number of Companies	Distribution	
			Percentage	Cumulative
Class I	Less than 1	2	0.2 %	0.2 %
Class II	1 to 2	3	0.3	0.4
Class III	2 to 5	46	4.0	4.4
Class IV	5 to 10	79	6.9	11.3
Class V	10 to 25	162	14.1	25.4
Class VI	25 to 50	141	12.3	37.6
Class VII	50 to 100	131	11.4	49.0
Class VIII	100 to 250	174	15.1	64.1
Class IX	250 to 500	105	9.1	73.2
Class X	500 to 750	57	5.0	78.2
Class XI	750 to 1,000	28	2.4	80.6
Class XII	1,000 to 1,250	28	2.4	83.1
Class XIII	1,250 to 1,500	21	1.8	84.9
Class XIV	1,500 to 2,000	23	2.0	86.9
Class XV	2,000 or greater	151	13.1	100.0 %
	Subtotal	1,151		
	E & F Rated Companies	13		
	Grand Total	1,164		

## **SECTION XII**

### **FINANCIAL SIZE CATEGORIES (FSC)**

## **SECTION XIII**

### **RATING DISTRIBUTIONS**

The following section provides the distribution of Best's Financial Strength Ratings on both an individual company and rating unit basis as of July 15, 2009. In addition, this section provides the distribution of companies assigned to Not Rated (NR) categories.



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The term “rating unit” applies to either individual insurers or a consolidation of member companies. The rating unit forms the financial basis on which A.M. Best performs its rating evaluation. The financial results of rating units more accurately represent the way insurance groups operate and manage their businesses. Therefore, the rating distribution based on a rating unit basis is the more appropriate rating distribution to gauge A.M. Best’s overall opinion of the financial health of the universe of insurance companies we rate.

**2009 LIFE/HEALTH RATING DISTRIBUTION\***  
**BY INDIVIDUAL COMPANIES**

<b>FSR</b>	<b>Rating Category</b>	<b>Number</b>	<b>Percent</b>
<b>Secure Ratings</b>			
A++	Superior	32	2.7%
A+	Superior	115	9.9
	<b>Subtotal</b>	<b>147</b>	<b>12.6</b>
A	Excellent	250	21.5
A-	Excellent	301	25.9
	<b>Subtotal</b>	<b>551</b>	<b>47.4</b>
B++	Good	159	13.7
B+	Good	118	10.1
	<b>Subtotal</b>	<b>277</b>	<b>23.8</b>
	<b>Total Secure Ratings</b>	<b>975</b>	<b>83.8%</b>
<b>Vulnerable Ratings</b>			
B	Fair	66	5.6%
B-	Fair	37	3.2
	<b>Subtotal</b>	<b>103</b>	<b>8.8</b>
C++	Marginal	35	3.0
C+	Marginal	22	1.9
	<b>Subtotal</b>	<b>57</b>	<b>4.9</b>
C	Weak	9	0.8
C-	Weak	4	0.3
	<b>Subtotal</b>	<b>13</b>	<b>1.1</b>
D	Poor	3	0.3
E	Under Regulatory Supervision	7	0.6
F	In Liquidation	6	0.5
	<b>Subtotal</b>	<b>16</b>	<b>1.4</b>
	<b>Total Vulnerable Ratings</b>	<b>189</b>	<b>16.2%</b>
	<b>Total Rating Opinions</b>	<b>1,164</b>	<b>100.0%</b>
<b>No Rating Opinions</b>			
NR-1	Insufficient Data	147	21.2%
NR-2	Insufficient Size/ Operating Experience	80	11.5
NR-3	Rating Procedure Inapplicable	90	13.0
NR-4	Company Request	21	3.0
NR-5	Not Formally Followed	356	51.3
	<b>Total No Rating Opinions</b>	<b>694</b>	<b>100.0%</b>
	<b>Total Reported Companies</b>	<b>1,858</b>	

\*As of July 15, 2009

**2009 LIFE/HEALTH RATING DISTRIBUTION\***  
**BY RATING UNITS**

<b>FSR</b>	<b>Rating Category</b>	<b>Number</b>	<b>Percent</b>
<b>Secure Ratings</b>			
A++	Superior	12	1.4%
A+	Superior	41	4.9
	<b>Subtotal</b>	<b>53</b>	<b>6.3</b>
A	Excellent	159	18.9
A-	Excellent	225	26.7
	<b>Subtotal</b>	<b>384</b>	<b>45.6</b>
B++	Good	127	15.1
B+	Good	105	12.5
	<b>Subtotal</b>	<b>232</b>	<b>27.6</b>
	<b>Total Secure Ratings</b>	<b>669</b>	<b>79.5%</b>
<b>Vulnerable Ratings</b>			
B	Fair	53	6.3%
B-	Fair	36	4.3
	<b>Subtotal</b>	<b>89</b>	<b>10.6</b>
C++	Marginal	34	4.0
C+	Marginal	22	2.6
	<b>Subtotal</b>	<b>56</b>	<b>6.6</b>
C	Weak	9	1.0
C-	Weak	4	0.5
	<b>Subtotal</b>	<b>13</b>	<b>1.5</b>
D	Poor	2	0.2
E	Under Regulatory Supervision	7	0.9
F	In Liquidation	6	0.7
	<b>Subtotal</b>	<b>15</b>	<b>1.8</b>
	<b>Total Vulnerable Ratings</b>	<b>173</b>	<b>20.5%</b>
	<b>Total Rating Opinions</b>	<b>842</b>	<b>100.0%</b>
<b>No Rating Opinions</b>			
NR-1	Insufficient Data	147	21.2%
NR-2	Insufficient Size/ Operating Experience	80	11.5
NR-3	Rating Procedure Inapplicable	90	13.0
NR-4	Company Request	21	3.0
NR-5	Not Formally Followed	356	51.3
	<b>Total No Rating Opinions</b>	<b>694</b>	<b>100.0%</b>
	<b>Total Reported Units</b>	<b>1,536</b>	

\*As of July 15, 2009



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## SECTION XIV

### DEFINITIONS

#### ORGANIZATION TYPES

Insurance transactions are conducted primarily through four types of organizations—stock companies, mutual companies, fraternal societies and non-profit organizations. A brief description of the legal structure and function of each is as follows:

- **Stock Companies:** Stock companies are corporations, the financial ownership of which is comprised of capital stock which 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.
- **Fraternal Societies:** Fraternal life insurance societies are purely mutual organizations, and the major fraternal societies furnish life insurance benefits to their members on a basis essentially the same as that utilized by legal reserve life insurance companies. The fraternal life insurance society is characterized by its lodge system, a representative form of government and its fraternal or benevolent activities.
- **Non-Profit Organizations:** Non-profit organizations are insurance companies that have no individuals/organizations with an ownership interest. Control of these companies rests with the board of directors. Non-profit companies reported on by Best are typically health or dental insurers.

#### INSURANCE LICENSES

In our reports we list the states, provinces, and territories in which a company is licensed or approved (where required) to do business. States have the authority to regulate insurance companies and have controlled insurance mainly through the licensing power. The license is a document that indicates an insurer has met the minimum requirements established by statute and is authorized to engage in the lines of business for which it has applied.

The importance of a company being licensed in a particular domicile determines not only the protection to the insured provided by the regulatory authorities to assist if a problem arises, but also the protection afforded the insured by guaranty fund laws, which generally apply only to licensed insurers. Each jurisdiction has its own statutes and there are a number of different licensing requirements.

In addition to licensed insurers, there are other specialty types of companies that exist in the field of insur-

ance such as reinsurers. A reinsurer is a company that agrees to indemnify, for consideration, the ceding company against all or part of a loss that the latter may sustain under policies that it has issued. Reinsurers do not always have to be licensed and may operate on an approved basis in some states.



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