

February 17, 2012

**Additional Information****Criteria:**

Understanding Universal BCAR

Understanding BCAR for Life &amp; Health Insurers

A.M. Best Ratings &amp; the Treatment of Debt

**2011 Special Report:**

Solvency II – Rating Implications Issue Review

**Analytical Contacts**

Stefan Holzberger, London

+44 207-397 0288

Stefan.Holzberger@ambest.com

Edward Easop, Oldwick

+1 (908) 439-2200 Ext. 5781

Edward.Easop@ambest.com

**Rating Members of Insurance Groups**

Today, insurance organizations operate in a truly global environment, with many industry participants establishing or maintaining multiple businesses in diverse geographic regions. Insurers have expanded their platforms beyond the traditional domiciles of the United States, Bermuda, Japan and western Europe and have branched out more recently into emerging markets such as Brazil, Russia, India and China, among others. In response to the globalization of the industry, various regulatory regimes are contemplating dramatic changes to insurers' financial, supervisory and disclosure requirements. A prime example is Solvency II, due to take effect in Europe in 2014, which seeks to address the global nature of the insurance industry by radically changing the regulatory landscape. (For commentary on the rating implications of Solvency II, please see A.M. Best's 2011 special report titled *Solvency II – Rating Implications Issue Review* at [www.ambest.com/research](http://www.ambest.com/research).)

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.

The purpose of this criteria report is to illustrate how A.M. Best evaluates members of insurance groups and to review what levels of rating enhancement or drag are placed on the 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.

For additional information on A.M. Best's approach to assigning ratings, and for complete definitions of A.M. Best's ratings, please refer to the Methodology section of Best's Rating Center, which is located online at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology).

This criteria report can be found at  
[www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology)



## Analyzing Groups

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 assessment is determined for all entities except those that possess a pooled or reinsured rating. A.M. Best's approach to rating pool members and reinsured affiliates is discussed later.

In cases where it is inconceivable for an insurer to exist without its membership within a larger organization (i.e. there would be no business to write without the parent company, as with a small subsidiary that exists solely for rate flexibility), a review of balance sheet strength and historic operating performance drives the stand-alone approach. Here, less emphasis is placed on the qualitative components of business profile – such as competitive market advantage, brand-name recognition and control of distribution – for the purposes of the stand-alone assessment.

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. Key questions may include:

- What resources are available to the organization as a whole in relation to its cumulative current and future financial obligations?
- What available excess capital can the group employ to support individual subsidiaries?

Note that A.M. Best defines excess capital as the difference between available capital and the required capital that must be in place to adequately support the organization's risks.

This top-down analysis highlights the benefit of diversification within an insurance group. Because of the less than complete correlation of individual risks, the total required capital at the consolidated group level is invariably less than the sum of its parts. As such, group capitalization, particularly where there is excess capital, can have a direct effect on subsidiaries' capital requirements and ratings. For further detail on how A.M. Best analyzes insurers' risk-adjusted capital, please see the Best's Capital Adequacy Ratio (BCAR) criteria reports found at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology).

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 assessments.

## Overview of Rating Enhancement/Drag

To be eligible for rating enhancement, the insurance subsidiary must operate under common ownership (greater than 50%) with the entity providing lift or maintain board control together with common management. An individual company can receive enhancement to its rating through support from its parent or from affiliated companies. This support can be explicit, such as through a guarantee, reinsurance agreement, capital infusion or pooling of assets and liabilities. Alternatively, it can be implicit support that ties the importance of the company to the overall organization. For example, a company or operating unit might provide important strategic or financial benefit to the organization's core operations, or it might in itself be an integral part of the group's core operation.

Existing reinsurance protection from a parent or affiliated company, or a prior capital infusion, is considered in the stand-alone analysis of the operating unit. However, the permanence of any capital contribution or reinsurance protection is an important aspect of any explicit support. As a result, the evaluation of explicit support must include a subjective review of the expected permanence of parental commitment to its subsidiary.

For this reason, Best's Ratings that incorporate parental support require ongoing surveillance to ensure there are no material changes to the degree of implicit and/or explicit parental support. As with all Best's Credit Ratings, the dynamics of each insurance group are re-evaluated continually for changes that might arise. A.M. Best maintains contact with company management throughout the year and monitors each company's performance and its strategic role within its group.

## Implicit Parental Support

### Overview

A.M. Best considers operating subsidiaries within a group for rating enhancement ranging from none to full rating enhancement. In the latter case, the company is assigned its parent's rating – assuming the parent providing lift is an insurer itself. In cases where the lift comes from a parent holding company (intermediate or ultimate) or a non-insurance affiliate, full rating enhancement would lift the stand-alone assessment to the lead insurance company's rating, which was determined through the enterprise-level analysis. In either case, lift is determined in the same way. Throughout this criteria report, either case will be referred to as the subsidiary receiving its parent's rating.

Companies that receive full rating enhancement maintain a strong affiliation with, or importance to, the parent. A.M. Best deems the security offered to the policyholders of these subsidiaries to be as strong as that offered to any policyholder within the group. Companies that receive no rating enhancement demonstrate the least strategic importance and potentially could cease operations or be sold with no material impact on the group's future success. These companies could be assigned ratings no higher than their stand-alone assessments, unless new,

explicit support is provided. Regardless of the subsidiary's perceived importance to the group, any subsidiary company's published rating could be lowered from its stand-alone assessment if there is a perceived drag from a weaker parent or affiliate.

Consideration of rating enhancement is based primarily on the level of implicit support expected from a parent or affiliate. However, the amount of explicit support already provided to the operating unit also influences the level of implicit support anticipated by A.M. Best and the level of benefit in a rating. These judgments are subjective and are decided by a rating committee following a formal rating review, which includes detailed discussions with management to gain a complete understanding of the organization, its individual members and the markets in which they operate.

There is no automatic increase in the subsidiary's published rating. A.M. Best determines the amount of enhancement provided in the published rating, if any, after considering the:

- Subsidiary's level of strategic importance to the parent.
- Subsidiary's integration within the group's operations.
- Differential between the subsidiary's stand-alone assessment and the parent's rating.
- Level of the parent's rating.
- Trends in the parent's and subsidiary's stand-alone assessments.
- Level of the subsidiary's stand-alone assessment.
- Amount of explicit support provided to date.

When a parent company's financial strength diminishes due to a shock loss or negative market event, clearly its ability to provide support to its subsidiaries also is reduced. If the parent's financial health were to deteriorate precipitously, particularly in cases where excess capital within the organization was to evaporate, any rating enhancement afforded to affiliates or subsidiaries would be reduced or

eliminated. In extreme cases, an impaired insurance company's ability to support its subsidiaries might be severely limited by regulatory restrictions. A.M. Best seeks to identify the potential for this in its analysis of rating enhancement and will remove rating uplift emanating from an unstable parent company.

In some cases, a subsidiary meets the criteria for rating enhancement, but its stand-alone assessment and published rating remain the same (e.g. A- stable outlook to A- positive outlook). The maximum benefit a stand-alone assessment can achieve through implicit support is two Financial Strength Rating levels (e.g., B+ to A-). However, additional lift is possible through explicit parental support (e.g., guarantee, net worth maintenance agreement). Examples of these and other situations will follow in the next section.

#### ***Implicit Support – Full Rating Enhancement***

A subsidiary is assigned its parent's rating (i.e. given full rating enhancement) if A.M. Best views the company to be integral to the group's primary business through its financial, operational and/or strategic importance. A.M. Best expects that under almost any scenario, the parent would continue to support the subsidiary to the extent of its financial ability. The sale or closure of such a subsidiary would imply an unexpected shift in the group's strategy. As a result, these subsidiaries are assigned the parent's rating and financial size category.

The operating performance of the subsidiary and its ability to meet A.M. Best's expectations are important in evaluating the rating enhancement. **Exhibit 1** details common characteristics of a subsidiary that is assigned its parent's rating.

Factors that may prevent a subsidiary from receiving full rating enhancement include: weak stand-alone capitalization, volatile historical or prospective earnings, and diminished business profile. As a matter of course, it is very unlikely that a newly started or acquired entity would be eligible for its parent's rating based on implicit support until it had demonstrated its contribution to the group's earnings. Therefore, a start-up would need explicit parental support (i.e. affiliated reinsurance, financial guarantee,

etc.) to achieve substantial rating lift. For an example of full rating enhancement, please see **Appendix A**.

#### ***Implicit Support – Partial Rating Enhancement***

The degree of affinity between subsidiary and parent differentiates those subsidiaries that receive the parent's rating from those that receive partial rating enhancement. The willingness of the parent to incur the financial impact of supporting such a subsidiary under stress is less certain. The subsidiary is not essential to the organization's success, and the sale or run-off of the operation would not imply a radical change in core business strategy. Nonetheless, A.M. Best believes the subsidiary is important enough to the organization that the parent would incur losses substantially greater than its legal obligation to keep the subsidiary in good financial standing.

The subsidiary's operating performance and its ability to meet A.M. Best's expectations are important considerations in assigning partial rating enhancement. Common characteristics of a subsidiary that is assigned partial rating enhancement are listed in **Exhibit 2**.

A subsidiary assigned partial rating enhancement can achieve a rating at the same level as its parent, but this rating still is considered a separate rating. As such, it does not maintain the parent's financial size category. Another key difference is that companies receiving full rating enhancement move up or down in lock-step with the parent. Partial rating enhancement that brings the subsidiary's rating to its parent's level does not imply that if the parent's rating goes up, so will the subsidiary's. In this case, the subsidiary's stand-alone assessment likely would have to improve, or its perceived level of implicit parental support would have to increase, before the subsidiary could receive an upgrade. **Appendix A** shows an example of a subsidiary that receives partial rating enhancement as a result of implicit parental support.

#### ***Implicit Support – No Rating Enhancement***

A subsidiary receiving no rating enhancement is viewed as a company that is an investment and not a key component of the group's long-term strategy. In these instances, the operating unit would be

## Exhibit 1

### Full Rating Enhancement Factors

Key issues relating to full rating enhancement include:

- Is critical to the group's strategy and ongoing success.
- Is fully integrated into the group's strategic plan.
- Carries the group name or is identified easily with the group.
- Is material to the business profile of the group.
- Is a significant contributor to the group's earnings.
- Currently benefits from some form of explicit parental support.
- Has a history of receiving explicit support when needed.
- Is necessary for rate flexibility.
- Is necessary for licensing.

assigned a rating equal to its stand-alone assessment. Common characteristics of a subsidiary that receives no rating enhancement are detailed under **Exhibit 3**.

It is important to note that a subsidiary may represent a successful investment but still receive no rating enhancement. However, the subsidiary's stand-alone assessment would reflect its success. For an example of a subsidiary receiving no rating enhancement, please see **Appendix A**.

### Capital Requirements for Subsidiaries

When reviewing an insurance subsidiary, A.M. Best determines the minimum level of capital the subsidiary must hold to maintain the rating. If there are restrictions on the free flow of capital, a greater capital requirement may exist at the subsidiary level. Several factors weigh into the capital requirement, including the:

- Subsidiary's historic and prospective performance.
- Risk appetite and shock-loss exposure.
- History of parental support
- Perceived future parental support.
- Fungibility of capital between the parent and subsidiary.

Under Solvency II, the intention is to hold insurance organizations to solvency capital requirements (SCR). Although the European Commission still is working out the details, the current proposal is to stipulate that each operating unit must maintain a predetermined, company-specific minimum amount of capital. In addition, thinly capitalized subsidiaries may be required to hold

## Exhibit 2

### Partial Rating Enhancement Factors

Key issues relating to partial rating enhancement include:

- Is important to the group's business strategy and profile.
- May operate on a more independent basis, such as through a separate identity or distribution platform.
- Has earnings that are not core to the group but are a good source of diversification.
- Is a meaningful contributor to the group's operating performance and/or financial strength.
- Has benefited from some form of explicit parental support.
- Is highly likely to receive future support.

a financial guarantee or net worth maintenance agreement from their parent.

A.M. Best takes a similar approach to its capital requirements at the subsidiary level. Using Best's Capital Adequacy Ratio (BCAR) as the measurement tool for required capital, together with the other key rating determinants (i.e. operating performance and business profile), all subsidiary companies that maintain a published excellent or above rating (i.e. A- or higher) are expected to maintain a secure stand-alone assessment. Importantly, a secure stand-alone assessment implies a level of capital that supports the assignment of at least a B+ rating.

To achieve rating lift beyond the two-notch maximum available through implicit support, the subsidiary would need to hold a comprehensive financial guarantee or net worth maintenance agreement from its parent. This would enable the subsidiary to possibly attain the parent's rating level, where the spread between the stand-alone assessment and published rating is greater than two notches. For more information on how explicit support such as parental guarantees and net worth maintenance agreements fac-

## Exhibit 3

### No Rating Enhancement Factors

A subsidiary that receives no rating enhancement is one that:

- Has marginal or incidental status to the group's overall strategy.
- Can be readily sold without material impact to the group's ongoing operations.
- Has a separate operating platform.
- Is managed independently with a separate market identity.
- Lacks business synergy with parent's core operations.
- Provides no meaningful diversification benefits.
- Is not a significant contributor to earnings or capital.

tor into rating enhancement, please see below. A.M. Best also conducts its BCAR

analysis at the consolidated group level to ensure that sufficient capital exists in aggregate and to cover all subsidiaries' capital requirements.

The subsidiary's level of capital plays a leading role in the assignment of the stand-alone assessment and also helps determine the potential for rating enhancement. As previously mentioned, the maximum rating enhancement through implicit support is two rating notches.

#### ***Non-Insurance Parent or Affiliate***

To rate individual insurance companies within a group, A.M. Best takes a top-down analytical approach, meaning it needs to analyze and understand the organization as a whole. Here, A.M. Best reviews the parent holding company to capture the entire group's performance and capital position. At this level, financial leverage and fixed charge coverage, liquidity, and asset quality and diversification, among others, are reviewed to ensure that the group, as a whole, is in good financial standing. This analysis helps determine the highest possible rating for any insurer within the group based on lift. Also, if the entity issues debt

#### **An Example of Rating Enhancement**

A New York subsidiary is wholly owned by a California-based parent insurer rated A-. If this subsidiary meets the requirements for receiving rating enhancement (as outlined above) and has a secure stand-alone assessment (minimum of B+), it could obtain an A- published rating. If, however, the entity met the requirements for receiving rating lift but did not maintain a secure stand-alone assessment, the insurer would not qualify for the A- rating. With a B stand-alone assessment, for example, the highest possible rating for the subsidiary through implicit parental support would be B++.

Next, assume the California parent has a financial strength rating of A+. And as before, the subsidiary maintains a B+ stand-alone assessment. If, based on the rating committee's review, the subsidiary qualified for lift, it could only obtain the A+ published rating either by increasing its stand-alone assessment to at least A-, or by obtaining a comprehensive financial guarantee or net worth maintenance agreement (i.e. explicit support) from its parent.

or hybrid securities to the public market, A.M. Best analyzes and rates these securities. For more information on A.M. Best's methodology for rating debt securities, please see the criteria report titled A.M. Best's Ratings & the Treatment of Debt at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology).

The purpose of the top-down approach is primarily to determine whether or not the parent company, or indirectly a non-insurance affiliate, is in a position to provide lift or drag to the rated insurance entities. For example, a group may have a manufacturing subsidiary that provides substantial earnings to the group. In addition, this entity may hold excess capital that could be made available to the insurance entities if necessary. Ready access to this affiliate's excess capital, plus the benefit of a diversified stream of earnings to the entire group, could provide lift to the stand-alone assessments.

Conversely, for a group with a premium finance affiliate that is depleting group capital due to excessive charge-offs, the insurers' ratings likely would be affected adversely by this affiliate that is draining the group's financial resources and hurting consolidated earnings.

A.M. Best reviews all members of a group for the potential benefit or drag an affiliate can represent. To gain comfort with a group's non-insurance affiliates, A.M. Best's analysts hold discussions with management to determine these entities' strategic fit. A review of these entities' stand-alone performance, balance sheet and risk appetite determines their contribution to the group relative to the other operations. Additionally, A.M. Best's analysts use public information, third-party analytical studies and industry reports, as well as their own analysis of management-provided information, to assess a non-insurance affiliate's financial condition.

#### **Explicit Financial Support**

Explicit financial support demonstrates a group's commitment to a subsidiary or affiliate. Such support comes in the form of a capital contribution or a contractual arrangement that exhibits the parental commitment, regardless of the subsidiary's fundamental importance to the group. Pool-

ing, internal reinsurance, guarantees and net worth maintenance agreements are examples of explicit support. In many cases, insurance groups use these tools to facilitate capital management by reducing the need to capitalize each subsidiary at a level consistent with their risk exposure before the contractual support.

The level of benefit afforded to an operating unit's rating depends on the type of explicit financial support provided. Insurers with pooled or affiliated reinsurance arrangements meeting A.M. Best's requirements are assigned the parent's rating. Guarantees, also discussed below, that offer full protection to a subsidiary can provide rating enhancement, and in some cases equalize the subsidiary's and parent's ratings.

### Treatment of Branches

A true branch is not a separate legal entity and is viewed as an extension of the home office. As such, policies are written on the paper of the legal entity of which the branch is a part. Therefore, a true branch is assigned the rating of the head office. This is the case in Canada, where many global insurers do business through a local branch operation.

A branch's rating treatment will be modified if, from a legal and/or regulatory perspective, the legal entity has an acknowledged limit to its exposure in meeting its branch's commitments. In such cases, A.M. Best treats the branch as if it was a limited liability subsidiary and rates it accordingly.

Questions have arisen regarding the treatment of branches based on liquidation preference between the home office policyholders and the branch office policyholders. The ratings apply to all insurance policies issued by an insurer as a single class of obligation. In effect, A.M. Best's rating opinion applies to the last policyholder in a liquidation scenario.

Although A.M. Best does not account for policyholder preference through a separate "expected loss" rating for branch policyholders, the potential disadvantage of the branch policyholder is considered in the rating assignment. As such, A.M. Best uses a qualitative framework that allows for the recognition

of disadvantages to branch policyholders. This allows A.M. Best analysts to capture directly, in the branch's rating, any weakness in policyholder security resulting from the branch being disadvantaged by legislation that protects home-office policyholders to the detriment of the branch. This diminished degree of financial security can take the form of subordination to home-office policyholders or some other stipulation limiting the branch operation's financial strength.

Highlights of this analytical approach are summarized below:

1) Ratings of branch operations will include an evaluation of the impact of home-office laws on branch policyholders' prospects for recovery (relative to the prospects of the home-office policyholder).

2) If the branch policyholder is deemed to be materially disadvantaged, the branch operation's rating could be notched lower than the home-office rating. As an example, if the branch policyholders only could access assets held domestically (i.e. no access to assets held in the home-office country), and these assets were deemed inadequate to cover all of the branch's financial obligations, the branch's rating likely would be notched downward from the home-office rating. Additional parental support, however, could prevent this outcome.

3) Legislation that may disadvantage a branch policyholder will not automatically result in a lower rating on the branch. At higher rating levels, A.M. Best could determine that the overall financial strength of the organization still may support comparable ratings on both the branch and home office. For example, if the organization's overall book of business was written 90% in the branch operation and 10% in the home office, subordination would be less of an issue. Conversely, in cases where certain legislation is deemed disadvantageous to a branch's policyholders, it would be more likely that a lower rated organization that is thinly capitalized might find its branch rating notched downward from the home-office rating.

4) The degree of notching between the branch and home-office ratings will depend on a number of factors, including A.M. Best's assessment of the potential

impact of legislation on the branch's financial strength; the level of the home-office rating; and the existence of an enforceable guarantee or other risk mitigation tool that may strengthen the branch's financial position.

5) The *Best's Credit Report* on the branch will include a statement reflecting any consideration given to the impact of home-office laws on the branch rating, such as the relative standing of branch versus home-office policyholders.

### **Pooled Affiliations**

A group whose member companies pool assets, liabilities and operating results maintains, in theory, the same operating performance and balance sheet strength as other companies within the pool. 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.

Intercompany pooling agreements generally contain the following provisions:

- The agreement among the pooled companies is joint and several.
- The pool is pure, meaning that all premiums, losses and expenses are shared based upon the pooling percentages, with the allocation of each being consistent with the allocation of unstacked surplus among the pool members. Pool percentages may need to be reallocated periodically because of the investment performance and dividend activity of individual pool members.
- Stand-alone capitalization supports the assigned rating after the pool is considered.
- The pool includes coverage for any prior-year loss-reserve development.
- The pool includes coverage for the run-off of all liabilities incurred on policies incepted prior to termination.
- A common, ultimate parent with ownership measured as greater than 50%; or control of the board of directors along with common management of each of the pooled members consistent with the lead company.

- A 12-month notice before the pool can be disbanded or a company can be removed from it.

Typically, all pool members are assigned the same rating and Financial Size Category, based on their consolidation. Companies that are members of pools that do not qualify for the pooled rating still can qualify for rating enhancement. Depending on the insurer's stand-alone rating and the strength of the pooling arrangement, together with any other explicit and implicit support provided, the insurer can receive the same rating – without the group financial size category – as the other companies within the pool.

### **Reinsurance Affiliations**

The reinsured rating is assigned to a company within a group that reinsures substantially all its insurance risk with an affiliated reinsurer. These intercompany reinsurance agreements generally contain the following provisions:

- Quota share of all premiums, losses and expenses written by the company unless regulatory restrictions apply (A.M. Best requires documentation from the regulator in these cases). In those cases, the retained percentage could be as high as the level required by regulation, to a maximum of 20%, but those cases would be subject to additional review.
- Stand-alone capitalization that supports the assigned rating, after consideration of the affiliated reinsurance and the incorporation of credit risk. For those companies with less than a 100% quota share, stand-alone operating performance also is considered in the analysis.
- A contract that contains no loss caps or loss corridors.
- 12 months' notice required before the reinsurance can be terminated.
- Reinsurance contract includes coverage for the runoff of all liabilities incurred on policies incepted prior to termination.
- Coverage for any prior-year loss reserve-development through the reinsurance arrangement.

- The assuming company has common ultimate ownership with the reinsured company, or common control through the board of directors together with common management.

Typically, reinsured affiliates are assigned the same rating and Financial Size Category as their reinsurer. Companies that do not qualify for the reinsured rating still may qualify for rating enhancement. Depending on the strength of the reinsurance contract and any other explicit and implicit support provided, the insurer can receive the same rating as the affiliate or parent company providing the reinsurance.

### Guarantees

The use of guarantees to show explicit support for a subsidiary's financial obligations has grown in recent years as groups optimize the efficient allocation of capital. A fully enforceable guarantee could protect the subsidiaries' policyholders without a potentially large, upfront capital infusion from the parent. However, the enforceability of guarantees – particularly those covering a large, geographically diverse population of policyholders – is always a concern.

Guarantees that result in rating enhancement generally contain:

- Coverage for all financial obligations of the subsidiary.
- A clear and satisfactory resolution to any foreseeable regulatory/jurisdictional conflicts.
- A termination notice of at least 12 months.
- Public disclosure of the guarantee.
- An assurance of enforceability, allowing policyholders/claimants to enforce the guarantee directly and locally within their own jurisdictions.
- Run-off coverage preserved for liabilities incurred on policies incepted prior to termination.

The mechanics and authority for triggering the guarantee must be clear. Also, in

some cases, a third-party legal opinion on the enforceability of a guarantee may be necessary for the guarantee to be considered for rating lift. It is important that the legal opinion address all regulatory and legal issues in each domicile that reasonably could apply to the guarantee.

If the above-noted factors are present, it is possible for a subsidiary to obtain its guarantor's rating. The rating committee determines the application of full rating enhancement, based on the factors noted in the above section titled "Implicit Support – Full Rating Enhancement."

Guarantees that are not ironclad are given consideration as explicit support and can still enhance the published rating. These guarantees, however, do not merit full rating enhancement up to the guarantor's rating level. Also, the guarantor's capacity to make good on a guarantee is considered in the guarantor's rating.

### Other Financial Support

A.M. Best evaluates other types of financial support – such as net-worth maintenance, stop-loss reinsurance and keep-well agreements – as part of the rating enhancement, so long as they are not evident in the company's financial performance. Once these support mechanisms are utilized, they become part of the stand-alone assessment.

Key factors that would result in favorable treatment by A.M. Best include:

- A contract without loss caps or loss corridors.
- A termination notice of at least 12 months.
- Run-off coverage that is guaranteed for the duration of the run-off of liabilities incurred on policies incepted prior to termination.
- Coverage for any prior-year loss-reserve development included in the protection.
- A clear confirmation of ability and willingness of minority owners to participate

in the protection if the company providing the protection does not have 100% ownership.

### **Summary**

The starting point for every rating is the stand-alone evaluation of the legal entity's balance sheet strength, operating performance and business profile. This analysis incorporates all in-place financial and operational support provided to the subsidiary from its parent that is evident in the subsidiary's financial results. Rating enhancement refers to provided, but unused, support (e.g. untapped guarantee or stop-loss reinsurance) and the potential for future parental support. Rating enhancement also can be derived from the inherent benefits the subsidiary enjoys simply through being part of a strong, diversified insurance organization (e.g., distribution channels).

A.M. Best understands that in today's dynamic market, being able to allocate

capital efficiently is a key competitive advantage. Through this criteria report, A.M. Best balances the policyholder protection afforded by the stand-alone financial strength of the legal entity, and the good-faith commitment of a parent to support the obligations of its subsidiaries. Regulatory regimes in Europe and elsewhere are tackling this same question. Solvency II is a direct attempt to incorporate the demands of the modern insurance marketplace into a new and improved regulatory framework.

A.M. Best believes a balance can be struck between in-place capital at the subsidiary level and a parental commitment to provide additional financial support when needed. A.M. Best encourages insurance organizations to speak to their analysts about their capital management strategies and highlight how each subsidiary operation fits into the group's overall business strategy.

## Appendix A

### Case Study of Varying Levels of Rating Enhancement Through Implicit Parental Support

A U.S.-headquartered insurance organization operates its global insurance business using three geographically distinct business platforms: London, the United States and Bermuda. The parent holding company in the United States possesses significant excess capital that is available to support its insurance operations. Through A.M. Best's top-down analysis of the consolidated group, the rating committee has determined that the highest pos-

sible insurer rating for the lead member of the group is A+. The parent company has expressed its commitment to each profit center, but it is clear that each holds a different level of importance to the overall earnings and business strategy of the group. The following paragraphs detail the unique features of the three business platforms and the important distinctions that drive the assignment of rating enhancement, or lack thereof.

#### Full Rating Enhancement

The London-based operating platform includes four European insurers located in England, Germany, France and Italy. The English and German carriers are composite insurers that write both life and non-life products, while the French and Italian insurers write life and annuity business. Each insurer is a market leader in its respective country, and together, these four insurance companies generate more than 70% of the group's total revenue and earnings. In addition, these entities employ roughly 50% of the group's capital and thus generate a solid risk-adjusted return. These companies consistently produce strong earnings with minimal volatility, and they are perceived to be at the heart of the parent's global business strategy. Much of the core competencies of the entire group are housed within this business center. As a result, the parent company in the United States has a track record of supporting these companies financially and operationally and has expressed its commitment to do so in the future.

The stand-alone assessment of each of these entities is A. They each are afforded full rating enhancement to the parent's rating of A+, mainly because of their:

- Importance to the parent's global strategy and contribution to its consolidated financial strength.
- History of receiving explicit support when needed.
- Lack of any regulatory restrictions as to the free flow of financial support from the parent.
- Significant excess capital held at the parent company.
- Solid, stand-alone financial strength.

#### Partial Rating Enhancement

In contrast to the London platform, the U.S. insurance hub consists of a large, national life and annuity company. This company's revenue and earnings comprise slightly more than 20% of the group's total, although it has experienced some negative swings in earnings in prior years due to its annuity products. This entity's required capital is 25% of the total group's required capital. The U.S. company operates under the same brand name as its affiliates in France and Italy and shares many back-office and product-development functions with these entities.

There is cross representation with regard to the board members of these three entities, and management at the parent holding company has expressed its commitment to this U.S. entity. Even so, it is clear that this entity is of secondary importance to the stronger-performing European operations.

The current stand-alone assessment of the U.S. entity is A- because of its solid capital position and well-established business profile, which are offset in part by a history of volatile earnings. The rating enhancement results in a published rating of A. The rationale for only giving partial rating enhancement is that the operation is deemed nonessential to the global business plan, and performance has been subpar in relation to the strong earnings generated by the European operations. And although the subsidiary does not qualify for full rating lift, it does receive partial lift because it:

- Is integrated with the business of the lead life and annuity writers.
- Is a material provider of earnings to the group.
- Carries the same brand name.
- Has close operational ties to the European life companies.

#### No Rating Enhancement

The third platform consists of a Bermuda property catastrophe reinsurer. In a good year, this entity comprises only 10% of revenue and earnings, but operating losses have been reported in three of the past five years. Because of the shock-loss exposure inherent in writing property catastrophe reinsurance, the capital allocated to this operation is high, roughly 25% of the group's required capital. This entity operates independently from the group, and from a brand name perspective is not immediately recognizable as a member of the group. Management of the parent company has stated that it stands behind all of its insurance operations, but also has told A.M. Best that the plan is to spin off this entity within the next two to three years. In addition, management has expressed distaste for the volatile earnings generated by this operation.

The stand-alone assessment of this entity is A- based on its very strong balance sheet, which is offset in part by a limited business profile and generally volatile earnings. This entity receives no rating enhancement because it is:

- Considered an investment by management with intent to sell in the near term.
- Not key to the group's global business strategy.
- Not a significant provider of earnings to the group.

Published by A.M. Best Company

## Methodology

CHAIRMAN & PRESIDENT **Arthur Snyder III**

EXECUTIVE VICE PRESIDENT **Larry G. Mayewski**

EXECUTIVE VICE PRESIDENT **Paul C. Tinnirello**

SENIOR VICE PRESIDENTS **Manfred Nowacki, Matthew Mosher, Rita L. Tedesco**

**A.M. BEST COMPANY**  
**WORLD HEADQUARTERS**  
 Ambest Road, Oldwick, N.J. 08858  
 Phone: +1 (908) 439-2200

**NEWS BUREAU**  
 830 National Press Building  
 529 14th Street N.W., Washington, D.C. 20045  
 Phone: +1 (202) 347-3090

**A.M. BEST EUROPE RATING SERVICES LTD.**  
**A.M. BEST EUROPE INFORMATION SERVICES LTD.**  
 12 Arthur Street, 6th Floor, London, UK EC4R 9AB  
 Phone: +44 (0)20 7626-6264

**A.M. BEST ASIA-PACIFIC LTD.**  
 Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong  
 Phone: +852 2827-3400



Copyright © 2012 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site [www.ambest.com](http://www.ambest.com).

Any and all ratings, opinions and information contained herein are provided "as is," without any expressed 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.

**A Best's Financial Strength Rating – Insurer** 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 policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does 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.

**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. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt 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.

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.

A.M. Best does not offer consulting or advisory services. A.M. Best is not an Investment Adviser and does not offer investment advice of any kind, nor does the company or its Rating Analysts offer any form of structuring or financial advice. A.M. Best does not sell securities. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

A.M. Best's special reports and any associated spreadsheet data are available, free of charge, to all *BestWeek* subscribers. On those reports, nonsubscribers can access an excerpt and purchase the full report and spreadsheet data. Special reports are available through our Web site at [www.ambest.com/research](http://www.ambest.com/research) or by calling Customer Service at (908) 439-2200, ext. 5742. Some special reports are offered to the general public at no cost.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.

SR-2008-M-136e