BEST'S RATING
Methodology

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Rating European Mutual Insurers

Contents

Related Reports

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Methodology:
A.M. Best's Perspective on Operating Leverage

Methodology:
Draft: Risk Management and the Rating Process for Insurance Companies

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This criteria report was updated as part of the annual review process. No substantive changes were made to the prior edition.

This criteria report can be found at *www.ambest.com/ratings/methodology*

This report outlines how A.M. Best applies its rating methodology to European mutual insurance companies. Throughout this methodology, the term "mutuals" will indicate any insurance company without capital stock and for which the ultimate control is vested in the policyholders.

Key Characteristics of Mutuals

While there are variations among mutual insurers, there are some characteristics that tend to apply to the majority of them and impact the way a mutual insurer is analysed. The most obvious differentiation from a stock company is the ownership of a mutual and the resulting implications.

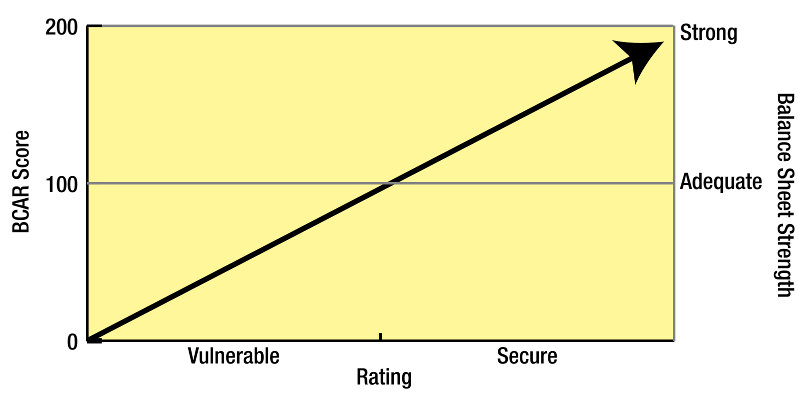
1. Ownership

The ultimate owners of mutual insurers are their policyholders, as opposed to the shareholders of stock companies. This results in significant differences in the way they attract business, their objective setting and their alignment with the ultimate owners' objectives.

Objectives – Lower Profit Expectations. The lack of traditional shareholder ownership means that most mutual insurers tend to focus mainly on serving their selected market segments. Typically, any profits may be either retained or distributed to policyholders as policy dividends or reduced premiums. Indeed, profitability targets and expectations of mutuals tend to be lower than those of competing proprietary companies. The acceptance of lower profitability tends to be in line with owner/policyholder expectations, especially as most mutuals operate in the personal lines market. Policyholders tend to be more interested in the competitiveness of the premium charged rather than the performance of their investment in the company they partly own.

Business Focus – Specific Segments. The mutuals' reduced focus on profitability is a competitive advantage that leads to greater market penetration in price-sensitive segments. Often, smaller sized mutuals tend to focus on a very well-defined niche – either regional or product specific. Further, there are several instances where the mutual is defined by its own niche, resulting in an exclusion of the main competitors in serving this segment. Typical examples of such mutuals would be companies

Typical Correlation of BCAR Score and Best's Rating



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serving a specific profession or trade union and providing preferential rates and service to the members. While it is possible for the profession/union members to seek competitive quotes elsewhere, their customer loyalty tends to be higher than that of competing companies. In all of the above cases, the mutual's strong business position results in high market penetration and/or improved retention of business when compared to proprietary insurers.

Controls and Governance. While mutual insurers' strategy tends to be aligned with the short-term objectives of their policyholders, the same cannot always be said of the alignment with the longer term objectives. Unsuccessful strategies of mutual insurers tend to have less immediate effects, especially for the management of the company, as the diverse ownership of the mutual shields it from either financial predators or indeed significant actions from its owners. It tends to be much easier for a small number of shareholders to drive significant changes in stock companies than to get agreement among the broadly dispersed ownership of a mutual. In many countries, mutuals tend to be regulated by mutual-specific regulators, with the result of divergence of regulation.

2. Capital

Lack of Equity. By far the more significant distinction between mutual insurers and their stock counterparts is the lack of traditional capital. Mutuals depend on the retention of profits in order to increase their surplus and thus support their claims-paying ability. This may not be a severe problem in periods of market profitability and stability. It is, however,

A Consistent Approach

A.M. Best is the pre-eminent agency for rating mutual insurance companies and currently maintains financial strength ratings on nearly 400 mutual (life, health and property/casualty) insurance companies, primarily in North America. In addition to mutual insurers, A.M. Best also rates other types of insurers that are not shareholder-owned companies, including fraternal benefit societies, reciprocals, protection and indemnity clubs, and not-for-profit insurers.

Regardless of whether a company is shareholder owned or operates as a mutual insurer, A.M. Best's rating methodologies are applied uniformly across all forms of ownership, with rating analysis focused on key tenets of balance sheet strength, operating performance and business profile.

The issues faced by mutual insurers mirror in many ways the concerns faced by stock competitors. Mutual companies have, however, traditionally maintained higher capital ratios than their peers. Thus, given the higher capitalisation levels, mutuals have generally reported lower returns on capital than stock companies. However, the efficient use of the excess capital to generate business growth, maintain competitive business profiles and provide market-rate operating returns on their business are viewed as key areas of strength for higher rated entities over the long term.

Competition has driven successful mutual companies to improve efficiencies and incorporate risk management practices and corporate governance in line with their stock counterparts. Mutual companies that maintain consistent balance sheet strength; strong business profiles with solid, well-established franchises; and continued operating profitability through the periods of both favourable and adverse development will continue to maintain higher ratings.

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a major drawback in cases of financial turmoil, such as when there are significant catastrophic events for the non-life market or equity market decline for life insurers. While mutuals retain the ability to ask their policyholders for additional contributions during such periods, this has not been an option oft exercised.

Economic Reserves. Mutuals can get a greater benefit in supporting their capitalization with economic reserves than can proprietary insurers. In many cases, the prevailing regulatory regimes encourage or prescribe the creation of financial reserves. Economic reserves are explicitly intended to be used in periods of financial hardship or alternatively to be shared between shareholders and policyholders. While the reserves apply to both proprietary and mutual insurers, the first have to ensure that such reserves are distributed equitably between policyholders and shareholders. Mutuals can utilize economic reserves in their totality in order to support policyholder liabilities rather than share them between shareholders and policyholders.

3. Financial Flexibility
The problem, though, still remains that the lack of traditional equity results in restricted financial flexibility. While this may not be the case for all types of mutuals – protection and indemnity clubs, for example, are able to call on their members for additional contributions – it is particularly true of the majority of mutuals that are focusing on personal lines of business.

The lack of traditional equity has also the additional implication that it is very difficult for mutual insurers to raise debt. Indeed, the raising of debt with equity characteristics that would be typically seen as part of a company's economic capital is almost impossible.

These two points result in reduced financial flexibility for mutuals, especially during the periods of high need. History has borne this out as the trend for demutualisation has tended to accelerate during or immediately after periods of financial distress, as mutual insurers have been trying to improve their risk-based capital position. Recent years have seen the introduction of the mutual holding company, i.e. an intermediate holding company that is ultimately owned by the mutual policyholders. While this goes a long way to alleviate the lack of financial flexibility, in most cases it results in the transformation of the company to a proprietary company in everything but name.

Analysing Mutual Insurers
The following discussions on Balance Sheet Strength, Operating Performance and Business Profile describe the most important considerations when analysing mutual insurers.

1. Balance Sheet Strength
In determining a company's ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its balance sheet strength, which measures the exposure of a company's surplus to its operating and financial practices.

Defining Economic Capital for Mutuals. Balance sheet strength is one of the areas where analysing mutuals differs most from the analysis of a proprietary company, as most mutuals lack traditional equity. In its analysis, A.M. Best uses a mutual insurer's net asset value as the company's economic capital. Apart from retained surplus, this includes the economic reserves accumulated and which have equity characteristics. Typically, these would include reserves reported in the company's balance sheet and which will be utilised to cover policyholder liabilities such as Free RfBs and Terminal Bonus Reserves in Germany, PPE and Reserve de Capitalisation in France, and Fund for Future Appropriations in the United Kingdom. Further credit is given for off-balance-sheet items such as the Orphan Estate in the United Kingdom. Whereas such reserves would be given a partial credit if they were for a stock company, for mutuals, the fact that the shareholders are also policyholders results in 100% credit in the balance sheet strength analysis.

The treatment of other forms of capital support such as the credit for value of in-force business, deductions for soft elements of capital (e.g. deferred acquisition costs, goodwill and the overvalue between book and market value of assets) is the same between the two types of insurers.

Financial Flexibility. Generally, A.M. Best views the financial flexibility of mutuals as more restricted than that of proprietary companies. Financial flexibility is restricted due to the lack of possible immediate and significant capital injections in the form of equity and the generally restricted access to financial markets. This is particularly important for mutuals with significant catastrophe exposures or high levels of annuity business that can result in significant outflows of money in a limited space of time. This can be alleviated by the formation of a mutual holding company, but these are analysed as stock companies rather than mutual insurers.

Catastrophe Stress Test. In addition to requiring a mutual to maintain surplus and economic capital that can withstand the net, after-tax hit to surplus from an initial catastrophe event, A.M. Best analysts perform a further stress test on the capitalization of a property/casualty insurer by adjusting Best's Capital Adequacy Ratio for a second catastrophic event. This analysis provides a preview of a company's BCAR score as if the event actually occurred, and it reflects the notion that the company's exposure remains the same after the event as it was on the day of the event.

Quality and Appropriateness of Reinsurance Program. Reinsurance plays an essential role in the risk-spreading process and provides insurers with varying degrees of financial stability. As a result, A.M. Best evaluates a mutual's reinsurance program to determine its appropriateness and credit quality. This program should be appropriate relative to the insurer's policy limits and underwriting risks, catastrophe exposures, business, financial capacity and the credit quality of the reinsurers involved. In addition, a reinsurance program should involve time-risk transfer and include reinsurers of good credit quality, since in the event of a reinsurer's failure to respond to its share of a loss, the reinsured or counterparty would have to absorb a potentially large loss in its entirety. To be considered adequate for catastrophe protection, a program needs to protect a property/casualty mutual from impairment or insolvency from large shock-losses such as a 100-year windstorm, or a 250-year earthquake, or its annual aggregate loss exposure. In addition, reinsurance should also provide protection from a series of smaller storm losses that do not trigger recovery from a traditional catastrophe reinsurance program. In addition to spreading risk, reinsurance can be utilized to leverage a mutual's surplus to enable it to write more business than would otherwise be possible.

For life/health mutual insurers, a reliable reinsurance program must consider sound risk management practices to provide the mutual with protection against adverse fluctuations in experience. Since these risk-transfer agreements on an underlying policy or policies indemnify the mutual for insurance risks, prudent evaluation of the economic impact on a mutual's life, health, and annuity operations is critical. Incorporating reinsurance to manage a mutual's financial risk that includes mortality, morbidity, lapse or surrender, expense, and investment performance presents a competitive risk to an insurer's future growth prospects and long-term viability. Therefore, the range of reinsurance must be evaluated with the mutual's ability to manage its growth relative to demands for life and health insurance coverage 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 mutual 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 mutual becomes insolvent or disputes claims coverage. It can also become a problem if general reinsurance rates, capacity, terms and conditions change dramatically following an industry event. The more a mutual is dependent upon reinsurance, the more vulnerable its underwriting capacity becomes to adverse changes in the reinsurance market. The greater this dependency, the greater A.M. Best's scrutiny of a mutual's reinsurance program to determine its appropriateness and credit quality and whether it is temporary or permanent in nature.

Adequacy of Loss/Policy Reserves. An evaluation of the adequacy of a mutual's reported reserves is essential to an evaluation of its profitability, liquidity and capitalization leverage. Net income and surplus are directly affected by changes in reported reserves. While A.M. Best does not audit a company's reserves, the reserve adequacy opinions of certified actuaries (internal and third party) supplement A.M. Best's review.

Loss reserve uncertainty for property/casualty companies is most pronounced in the area of emerging mega-liabilities, such as asbestos, environmental and pollution, and other mass torts. While the uncertainty and earnings drag associated with asbestos and environmental liabilities of insurers have diminished through favourable claims and settlement trends and improved financial disclosures, the property/

casualty industry remains exposed to several other potential mega-liabilities, which include electromagnetic fields, lead poisoning, sick building syndrome, silicone breast implants and tobacco litigation. Reserves play an important role in determining the balance sheet strength and flexibility of an insurance carrier, as well as its underlying profitability. The ability to predict ultimate reserve requirements is as much an art form as it is a science. Actuaries who certify a company's reserves typically provide management with a range within which loss and loss-adjustment expense reserves are deemed adequate. The range of reserve adequacy estimated by actuaries can be very significant. For casualty-oriented insurers, a 25% deficiency in current reserves may exceed policyholders' surplus and, therefore, render them technically insolvent. For property/casualty companies, A.M. Best evaluates reserving trends through its proprietary loss reserve model to measure any equity imbedded in a company's loss reserves. Upon determining A.M. Best's estimate for a company's ultimate loss reserve position, it is discounted to determine an economic loss reserve position. Any difference (deficiency or redundancy) between this economic reserve level and a company's carried loss reserve level is then applied to our proprietary capital adequacy model (BCAR).

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

For life/health companies, A.M. Best reviews the valuation methodology, interest assumptions and degree of conservatism in the establishment of life, health and annuity reserves. A.M. Best also evaluates 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, A.M. Best's confidence declines in a company's reported profitability, liquidity and leverage (capitalization).

Quality and Diversification of Assets. The quality and diversification of assets contributes to a mutual's financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) are evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The better the liquidity, diversification and/or quality of the assets, the less uncertainty there is in the value to be realized upon their sale and the less the likelihood of default. Therefore, a review of a mutual's invested assets is performed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large, single investments that exceed 10% of a mutual's total surplus. Mutual insurers that hold illiquid, undiversified and/or speculative assets, and that have a significant underwriting exposure to volatile lines of business that are vulnerable to unfavourable changes in underwriting and/or economic conditions, can jeopardize policyholders' surplus.

Liquidity. Liquidity measures a mutual's ability to meet its anticipated short- and long-term obligations to policyholders and other creditors. A mutual'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 mutual's ability to satisfy its financial obligations without having to resort to selling long-term investments or affiliated assets, A.M. Best reviews a mutual's quick liquidity, which measures the amount of cash and quickly convertible investments that have a low exposure to fluctuations in market value. A.M. Best also reviews current liquidity to measure the proportion of a mutual'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, A.M. Best evaluates the quality, market value and diversification of assets, particularly the exposure to large, single investments relative to capital. In order to measure a life mutual'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 mutual's financial strength, the economy, the financial markets and/or a mutual's media profile. The immediate liquidity analysis begins with an assessment of a life mutual's liability structure and the withdrawal characteristics of its policies and contracts. Mutual insurers 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 mutual is to a potential "run" and its ability to satisfy its obligations to policyholders in the event a "run" is triggered. Included in A.M. Best's review is the size of the contracts issued, applicable surrender charges or market-value adjustments, withdrawal restrictions, the types of distribution systems utilized, financial incentives which may exist for the replacement of policies, the level of highly liquid assets maintained, the strength and trends of cash flows, and individual mutuals' media profiles.

2. Operating Performance

Profitability. When evaluating operating performance, A.M. Best's analysis centres on the stability and sustainability of the company's sources of earnings in relation to the liabilities that are retained by the company. Since long-term balance sheet strength is generally driven by operating performance, greater importance is placed on operating performance when evaluating insurers writing long-tail business. Conversely, operating performance is weighted less heavily for those insurers writing predominantly short-tail business that also possess very strong capitalization and a stable business profile.

As mentioned earlier, mutuals tend to place less emphasis on technical profitability and more on overall operating performance. Indeed, it is this focus, combined with their mutual ownership, that provides them with their main competitive advantage. For this reason, A.M. Best believes that typical measures of profitability such as ROE, return on premium or combined ratio are not the best ways of measuring the operating performance of a mutual insurer.

Distinction needs to be made between mutuals in a stable market condition and those in a phase of strong growth, either because of expansion into new markets or during the early stages of their operational life. During these phases, profit accumulation is as important as for proprietary insurers, and therefore the traditional metrics of profitability apply.

3. Business Profile

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 mutual's ability to meet its obligations to policyholders.

Mutuals competing in the open market. In most cases, mutuals will be in direct competition with all other insurers operating in the same market. Examples of such cases would be the life mutual insurers being in direct competition with all other proprietary life insurers. While it can be claimed that there are periods in the insurance cycle that would work to the benefit of the mutual insurer, their benefit is limited. In such cases, A.M. Best believes that a mutual insurer's business position is no more secure than that of any other insurer. The analysis of such mutuals is therefore focusing on analysing their position in the overall market and the dynamics of the markets in which they operate.

Mutuals in protected or preferred market segments. However, there are certain markets where the mutual companies dominate, meaning that few proprietary insurers can obtain the scale and credibility to compete (e.g., health care mutuals in France). Furthermore, there are cases where mutuality is the only form of approved operation in a given market, such as in the case of the family takaful insurers. In such cases, it is highly unlikely that the insureds of the mutual would consider being insured by a stock insurer.

Similarly, there are mutuals that have preferential access to a specific segment due to their affiliation with not-for-profit organisations, e.g., mutuals focusing on the provision of products to a specific union membership.

In all these cases, A.M. Best analyses the mutual's business position not as a part of the overall market but as part of the specific segment in which it operates and based on the dynamics of the segment itself.

Spread of Risk. A mutual's book of business must be analyzed by line in terms of its geographic, product and distribution diversification. However, the size of a mutual, measured solely by its premium volume, cannot be used to judge its spread of risk. Generally, large mutual insurers have a natural spread of risk. Similarly, a small mutual that 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 mutual, with the exception of regulatory or residual market risks. For property/casualty mutuals, the geographic location of a book of business can have a great impact upon its exposure to catastrophic losses such as terrorist attacks, hurricanes, tornadoes, windstorms, hail or earthquakes.

For property insurers, A.M. Best requires a mutual to perform some degree of natural catastrophe modelling on its book of business. Property insurers with potential exposures that have never performed weather and earthquake-catastrophe modelling are effectively required to do so in order to qualify for A.M. Best's Secure ratings (A++ to B+). A.M. Best believes that natural catastrophe modelling is critical and plays an important role in prudently managing underwriting exposures. A.M. Best gathers catastrophe exposure and related reinsurance protection data through its Supplemental Rating Questionnaire. For life and health mutuals, the mix of business must be evaluated with respect to the distribution and performance of the underlying assets, as well as a mutual'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 mutual 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 mutual 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 mutual, which can have either a beneficial or an adverse effect on a mutual's prospective profitability. Underwriting income, investment income, capital gains, asset values and, consequently, surplus can be significantly affected by external changes in economic, regulatory, legal and financial market environments, as well as by natural and man-made catastrophes.

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. A.M. Best's understanding of the operating objectives of a mutual's management team and their alignment with policyholders' long-term objectives play an important role in the qualitative evaluation of the current and future operating performance of a mutual.

Insurance Market Risk. Insurance market risk reflects the potential finance volatility that is introduced by, and associated with, the segment(s) of the insurance industry and/or the financial services sectors within which an organization operates. Such risks may also be considered systemic risks and are generally common to all market participants (i.e. financial services reform, 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 a mutual insurer's financial strength and its Best's Rating. When a sudden or unexpected event occurs, A.M. Best evaluates the financial and market impact on 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 mutual. Event risk may include changes in management, changes in distribution, a legal ruling or a regulatory development. Finally, event risks can also be influenced by potential regulatory or legislative reforms, economic conditions, interest rate levels and financial market performance, as well as societal changes.

Enterprise Risk Management (ERM)

A.M. Best considers ERM as a natural extension of an insurer's fundamental risk management practices, with the foundation still rooted in sound traditional controls and policies encompassing the main risk categories: credit, market, underwriting, operational and strategic.

The main principles of the ERM analysis undertaken are the same between mutuals and proprietary insurers. In cases where there is different regulatory supervision of mutuals, an opinion on the strength of such supervision and the importance of controls is established. This impacts A.M. Best's view of the market as a whole, which in turn influences the ratings of the companies operating within the market. The controls that are established by the companies, and that are over and above those stipulated by the regulators, will have a significant impact on the final rating of the mutual. Finally, for mutuals, emphasis is placed on their longer term objectives and their viability and alignment with the long-term objectives of their policyholders.

Appendix

Capitalisation Tests

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

Net Premiums Written to Policyholders' Surplus: This ratio compares a mutual's net retained premium to its policyholders' surplus and measures the mutual's exposure to pricing errors in its current book of business.

Net Liabilities to Policyholders' Surplus: This ratio measures a mutual's exposure to errors of estimation in its loss reserves and all other liabilities. The higher the loss-reserve leverage, the more critically a mutual insurer's solvency depends upon having and maintaining adequate reserve levels.

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

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

Gross Leverage: This ratio measures a mutual insurer's gross exposure to pricing errors in its current book of business; to errors in estimating its liabilities; and to its reinsurers.

Best's Capital Adequacy Ratio (BCAR): The BCAR score compares an insurer's adjusted surplus relative to the required capital necessary to support its operating and investment risks. Companies deemed to have "adequate" balance sheet strength normally generate a BCAR score of over 100% and will usually carry a Secure Best's Rating. Companies deemed to have strong balance sheet strength generate a BCAR score over 200%. The level of capital required to support a given rating level varies by mutual insurer, depending on the mutual's 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 potential catastrophe losses and future operating losses. Net Required Capital, for property/casualty insurers, is calculated as the necessary level of capital to support seven broad risk categories: Fixed Income Securities; Equity Securities; Interest Rate; Credit; Loss and Loss Adjustment Expense (LAE) Reserves; Net Written Premiums; and 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 mutual insurer's total capital requirement by recognizing that the risks associated with many of the seven categories are independent and may not occur at the same time.

For life/health insurers, this ratio incorporates into a single measure the financial impacts of several distinct risk components. BCAR utilizes the Credit Risk, Underwriting Risk, Interest Rate Risk and Business Risk classifications, from which a required level of capital to support these broad risks is derived. BCAR contains a covariance adjustment, in recognition of the fact that certain risk categories are mutually exclusive. Generally, over two-thirds of a property/casualty mutual's net capital requirement is generated from its Loss and LAE Reserves and Net Written Premiums risk components. These are influenced by its business profile, including distribution of premium by line and location; size; underwriting leverage; loss-reserve adequacy and stability; and premium rate adequacy. Conversely, generally over two-thirds of a life insurance mutual insurer's net capital requirements are generated by Credit Risk and Interest Rate Risk.

Key Loss Reserve Tests:

Loss and LAE Reserves to Policyholders' Surplus: This ratio measures the trend and magnitude of loss reserves to surplus. The higher the multiple of loss reserves to surplus, the more critical reserve adequacy becomes to an insurer's solvency.

Development to Policyholders' Surplus: This ratio reflects the degree to which year-end surplus was either overstated or understated in each of the past several years.

Development to Net Premiums Earned: If premium growth has been relatively steady, and if the product mix has not changed materially, this ratio measures whether or not a company's loss reserves are keeping pace with premium growth.

Key Liquidity Tests:
Quick Liquidity: This ratio measures the proportion of net liabilities covered by cash and investments that can be quickly converted to cash. This ratio may indicate a mutual's ability to settle its outstanding liabilities without prematurely selling long-term investments.

Current Liquidity: This ratio measures the proportion of liabilities covered by unencumbered cash and unaffiliated investments. If this ratio is less than 100, the mutual's solvency is dependent on the collectibility of premium and reinsurance balances and the marketability of investments in affiliates.

Overall Liquidity: This ratio indicates a mutual's ability to cover net liabilities with total assets. This ratio does not address the quality and marketability of premium balances, other receivables, affiliated investments and other assets.

Operating Cash Flow: This test measures a mutual's ability to meet current obligations through the internal generation of funds from insurance operations. Negative balances may indicate unprofitable underwriting results or low-yielding assets.

Non-Investment Grade Bonds to Policyholders' Surplus: This test measures exposure to non-investment grade bonds as a percentage of policyholders' surplus. Generally, non-investment grade bonds carry higher default and illiquidity risks.

Mortgages & Real Estate to Policyholders' Surplus: Mortgage loans and real estate (home office property, foreclosed mortgage loans and investment real estate) as a percentage of policyholders' surplus.

Affiliated Investments to Policyholders' Surplus: Affiliated investments (including home office property) as a percentage of policyholders' surplus.

Key Profitability Tests For Non-Life Mutuals:
Loss Ratio: This ratio measures the mutual's underlying profitability, or loss experience, on its total book of business.

Expense Ratio: This ratio measures the mutual's operational efficiency in underwriting its book of business.

Combined Ratio after Policyholder Dividends: This ratio measures the mutual's overall underwriting profitability. A combined ratio of less than 100 indicates the mutual has reported an underwriting profit. Mutual insurers in stable market positions are expected to have higher combined ratios than comparable proprietary insurers.

Operating Ratio: The operating ratio measures a mutual's overall pre-tax operational profitability from underwriting and investment activities. An operating ratio of less than 100 indicates a mutual is able to generate a profit from its core operations.

Pretax Return on Revenue: This ratio measures a mutual's operating profitability and is calculated as pretax operating income divided by net premiums earned.

Yield on Invested Assets: This ratio measures the average return on a mutual's invested assets before capital gains/losses and income taxes.

Change in Policyholders' Surplus: This ratio measures the annual change in a mutual's policyholders' surplus derived from operating earnings, investment gains, net contributed capital and other miscellaneous sources.

Return on Policyholders' Surplus: This ratio measures a mutual's efficiency in utilizing its surplus on a total return basis. "Total return" is calculated as the overall, after-tax profitability from underwriting and investment activity, including unrealized capital gains.

Key Profitability Tests for Life Mutuals:
Benefits Paid to Net Premiums Written 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 Net Premiums Written 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.

Net Operating Gain 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 mutual's total asset base.

Net Operating Gain 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 Policyholders' Surplus: Net operating gain (after taxes) as a percentage of the mean of current and prior-year policyholders' surplus. This test measures insurance earnings in relation to the mutual's policyholders' surplus base.

Net Yield: Net investment income expressed 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.

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