August 13, 2014

A.M. Best Publishes the Results of the Consultation Process for "Rating Surety Companies"

Effective 20 June 2013, The European Securities and Markets Authority (ESMA) has published new guidelines, CRA III, which have introduced a variety of new disclosure / consultation requirements where new criteria reports are introduced, or where material changes are made to the existing methodology.

On May 1, 2014, "Draft: Rating Surety Companies" was posted on the A.M. Best website for a one-month public consultation period. During the consultation process, two comment letters were received. In accordance with Article 8.6(ab), the results of the consultation process for "Rating Surety Companies" are published below including a summary of the comments received, A.M. Best's responses, and the two comment letters.

I. Comment Letter #1: Travelers

A. Recognition of Diversification

Comment: An approach which compares and selects the higher of a potential surety loss estimate, a recent large loss, or a catastrophe PML estimate would recognize the diversification of uncorrelated events.

- Response: A.M. Best agrees that the approach described in the comment would be consistent with the approach described in the current BCAR criteria. The draft surety criteria currently states that it if the insurer writes both surety and bail then the potential losses used in BCAR will be based on the higher potential losses from surety or bail. The surety criteria will be modified to further clarify that if the insurer also writes other lines of business that are exposed to other uncorrelated catastrophe losses, then the potential large losses used in BCAR will be the higher of surety, bail, catastrophe, or other potential/actual large loss.

B. Stochastic Modeling Approach

Comment: The potential loss in the surety criteria should consider loss frequency, and the proposed deterministic approach is punitive to capital and surplus compared with the approach used for property catastrophe surplus adjustments. However, it is acknowledged that there is no publicly available frequency statistics for the surety industry and the proposed deterministic approach is a reasonable stress analysis for companies that do not maintain stochastic models for their surety portfolios. However, sophisticated sureties should be allowed to provide a loss estimate using its own stochastically modeled surety Probable Maximum Loss (PML).

- Response: Due to the high severity/low frequency nature of surety losses, combined with the lack of credible historical industry data for high severity losses, A.M. Best believes that a more deterministic approach to estimate a potential large loss for use in its evaluation of balance sheet strength is appropriate. However, during the interactive rating process, insurers are encouraged to share their views on their exposure to potential large losses and how they model, monitor, and manage that risk. Therefore, no change will be made to the surety criteria for this comment.

C. Consideration of Commercial Surety Exposures

Comment: The proposed draft does not include consideration of a company's large non-construction commercial surety exposures.

- Response: A.M. Best will evaluate non-construction commercial surety exposures on a similar basis, where applicable. For instance, if the portfolio consists of several large potential loss exposures then they will be evaluated in a similar manner to construction commercial surety exposures by estimating a potential large net loss for each large exposure and using the two largest potential losses in BCAR. However, if the exposures are smaller and are more effectively analyzed on an aggregate basis, then the aggregate exposure will be considered using an approach that is similar to the approach used on other property/casualty lines of business where non-catastrophe premium and reserve risks are captured through the use of capital factors in BCAR. The surety criteria will be modified to include this response.

D. Consideration of Multiple Large Losses

Comment: The occurrence of a single large loss is a low probability event, and the inclusion of two large losses in the proposed BCAR stress test is excessively conservative. However, consideration of multiple events for smaller sureties with less analytic capabilities may be prudent.

- Response: A.M. Best believes that during certain economic environments, conditions could exist that would cause more than one large loss to occur within a relatively short time period. A.M. Best has observed many low probability events occur historically and believes that when assessing an insurer's ability to pay claims, stressing the balance sheet with large potential losses irrespective of the probability of the loss is a reasonable approach. A.M. Best prefers to have one consistent BCAR treatment for all sureties. Sureties with less analytic capabilities would be viewed less favorably during the review of qualitative factors and may be required to maintain higher capital levels or assigned lower ratings. Therefore, no change will be made to the surety criteria for this comment.

E. The Use of Loss Severity Factors Provided by the SFAA

Comment: Due in part to possible loss mitigation strategies, low historical losses, and limited large loss data at the 95th percentile, the PML statistics published by the SFAA are more statistically credible when the 90th percentile factors are used, rather than the proposed 95th percentile factors.

- Response: A.M. Best has considered this feedback and prefers to use the more statistically credible 90th percentile factors published by the SFAA. The surety criteria will be modified to reflect this change. In addition, for surety writers whose largest exposures are located outside the U.S., potential large losses will be developed based on information provided by the surety company pertaining to its largest exposures, including open limits, limits expired in last 12 months, cost to complete, historical large losses incurred, reinsurance program, co-sureties, etc. A.M. Best will revise the the surety criteria to reflect this clarification.

F. Explicit Consideration of Qualitative Factors

Comment: The comprehensive outline of qualitative factors listed in the criteria should result in an adjustment to the calculation of potential losses for a surety company in BCAR.

- Response: A.M. Best recognizes the importance of the qualitative factors evaluated in the criteria and rather than adjusting the potential losses in BCAR, surety companies viewed less favorably during the review of qualitative factors may be required to maintain higher capital levels or assigned lower ratings. This is treatment is consistent with how A.M. Best reflects qualitative factors in the rating of other P/C companies. Therefore, no change will be made to the surety criteria for this comment.

G. Business Implication

Comment: To the extent the proposed criteria contains overly conservative capital requirements, then it may put a surety company at a competitive disadvantage to other financial institutions that offer aggressively priced bank guarantees and letters of credit as alternatives to surety bonds.

- Response: Banking instruments are typically not insurance products, but are most often loans that must be paid back if used by the customer, and the difference in the pricing of insurance products versus banking products reflects the level of protection provided to the customer. A.M. Best is comfortable that the approach published in the surety criteria, which has incorporated considerable feedback from market participants during its development, provides for consistent evaluation of surety companies and uses reasonable capital charges that are appropriate to the risk characteristics of surety insurance. Therefore, no change will be made to the surety criteria for this comment.

II. Comment Letter#2: Surety & Fidelity Association of America (SFAA)

A. Recognition of Diversification

Comment: An approach which compares and selects the higher of a probabilistic surety loss estimate, a recent large loss, or a catastrophe PML estimate would recognize the diversification of uncorrelated events.

- Response: A.M. Best agrees that the approach described in the comment would be consistent with the approach described in the current BCAR criteria. The draft surety criteria currently states that it if the insurer writes both surety and bail then the potential losses used in BCAR will be based on the higher potential losses from surety or bail. The surety criteria will be modified to further clarify that if the insurer also writes other lines of business that are exposed to other uncorrelated catastrophe losses, then the potential large losses used in BCAR will be the higher of surety, bail, catastrophe, or other potential/actual large loss.

B. The use of Loss Severity Factors Provided by the SFAA

Comment: Due in part to loss mitigation strategies and low historical losses, the SFAA recommends that the 90th percentile factors, rather than the proposed 95th percentile factors, be used when estimating a PML statistic in BCAR.

Response: A.M. Best has considered this feedback and prefers to use the more statistically credible 90th percentile factors published by the SFAA. The surety criteria will be modified to reflect this change. In addition, for surety writers whose largest exposures are located outside the U.S., potential large losses will be developed based on information provided by the surety

company pertaining to its largest exposures, including open limits, limits expired in last 12 months, cost to complete, historical large losses incurred, reinsurance program, co-sureties, etc. A.M. Best will revise the surety criteria to reflect this clarification.

C. Stochastic Modeling Approach/ Consideration of Multiple Large Losses

Comment: A stochastic approach rather than deterministic approach should be used to estimate a large surety loss, and for large surety companies it may not be accurate to use the two largest net potential losses as a stress scenario in BCAR. A better evaluation could be obtained if surety companies were divided into small, medium, and large sized surety companies. For large surety companies, its largest accounts are large clients thought to have extremely low frequency of loss, and one potential loss from one large account would be more appropriate, not two. Furthermore, using potential losses from three accounts to stress the small sized sureties, and two potential losses from two accounts to stress the medium sized sureties, would be more appropriate.

- Response: A.M. Best believes that during certain economic environments, conditions could exist that would cause more than one large loss to occur within a relatively short time period. A.M. Best has observed many low probability events occur historically and believes that when assessing an insurer's ability to pay claims, stressing the balance sheet with large potential losses irrespective of the probability of the loss is a reasonable approach. A.M. Best prefers to have one consistent BCAR treatment for all sureties. Sureties with less analytic capabilities, or with lower credit quality insured principals, would be viewed less favorably during the review of qualitative factors and may be required to maintain higher capital levels or assigned lower ratings. Therefore, no change will be made to the surety criteria for this comment.

D. Technical Clarifications

Comment: The SFAA would like some clarification on how the co-surety percentages will be calculated. The SFAA suggests the limits of all co-sureties be combined in order to look up the correct PML which is based on total exposure. In cases where the co-surety percentages vary, the average co-surety percentage for that principal should be used.

Response: A.M. Best will most likely calculate a weighted average co-surety percentage using the bond limits as the weighting if there are multiple co-sureties for one principal or if co-sureties are used on a portion of the bonds for one principal. However, there may be circumstances that would require analytical judgment that would change the selected percentage, such as substantially different terms and conditions in the co-surety contracts, or financially impaired co-sureties. A.M. Best believes that Exhibit 2 is sufficient in showing that credit will

be given for co-sureties in the calculation of the net loss, but the details of the calculation are not needed for the criteria. Therefore, no change will be made to the criteria for this comment.

Comment: The SFAA would like some clarification on how excess-of-loss reinsurance will be evaluated and recommend that A.M. Best verify that at least one reinstatement has been purchased. In addition, how would reinsurance then be reflected in the 3rd through 5th largest potential losses.

- Response: Treaty and excess-of-loss reinsurance will be evaluated to determine the net loss. The original limits are assumed to be available to each of the largest exposures when calculating the net loss. Once the two largest exposures are determined, if the available limits become exhausted in the calculation of one of the two largest exposures, then a reinstatement premium may be added, if material. A.M. Best believes that Exhibit 2 is sufficient in showing that credit will be given for excess of loss and quota share reinsurance, but the details of the calculation are not needed for the criteria, especially since the reinsurance contracts and structures can be different for each surety. Therefore, no change will be made to the criteria for this comment.

Comment: The SFAA would like some clarification on how A.M. Best chose the 40% factor when estimating year-end reinsurance recoverables and net loss reserves?

- Response: The 40% factor was selected based on a review of the speed of reinsurance recoveries collected and the speed of loss payments made by catastrophe exposed insurers shortly after a catastrophe occurred. The stressed BCAR is not a year-end BCAR, but is intended to represent what the BCAR would like shortly after the large loss occurred (60-90 days). The 40% factor represents how much of the original total recoverable was still uncollected from reinsurers after that time period and how much of the original net loss was still unpaid by the surety after that time period. The 40% factor may be adjusted based on the structure and quality of the reinsurance program. For example, if the net losses incurred cannot develop any higher than the booked loss due to an excess of loss contract that caps the surety's net loss, then the 40% net loss added to the reserve page can be eliminated. The surety criteria will be modified to clarify that the factor may be adjusted based on the reinsurance contract.

E. Stress Test

Comment: The SFAA suggested that the criteria should include an example of the contract surety stress test calculation model.

- Response: A stressed BCAR calculation will not be included in the criteria. However, an exhibit showing sample adjustments made in a stressed contract surety BCAR will be included.

F. Wording Revisions

Comment: The nomenclature should be changed from "Largest Principals" to "Largest Exposures" when describing the accounts that will be used for the loss estimate in BCAR.

- Response: A.M. Best will revise the surety criteria to reflect this suggestion.

TRAVELERS

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June 2, 2014

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Re: May 1, 2014 Exposure Draft: Rating Surety Companies

Mr. Altonji:

Thank you for the opportunity to comment on the May 1, 2014 Exposure Draft: Rating Insurance Companies. We appreciate the consideration given to our prior discussions on this topic, most recently during our January 14, 2014 meeting with Michael Russo, Joel Silverthorn, Scott Dodd and Thomas Mount. As the leading U.S. surety company with over 100 years in the surety business we believe Travelers is uniquely positioned to provide valuable insight on this important topic, and we welcome a more refined and tailored rating analysis that considers the specific exposures and capabilities of a surety company. This letter provides Travelers' comments on the referenced Exposure Draft.

As you know from your discussions with and analysis of surety companies, there are significant differences in the business approach, risk appetite, risk management, loss reserving practices, loss mitigation mechanisms and analytical/statistical capabilities among sureties. The common thread however is that surety is a low frequency, high severity business. Accordingly, we fundamentally agree with a rating methodology that stresses surplus based on potential surety loss exposure. We do however have specific comments and observations on the proposed methodology for rating surety companies that we have categorized as follows:

- Recognition of Diversification
- Stochastic Modeling Approach
- Consideration of Commercial Surety Exposures
- Consideration of Multiple Potential Large Losses
- Surety & Fidelity Association of America (SFAA) Loss Severity Study Factors
- Explicit Consideration of Qualitative Factors
- Business Implications

Recognition of Diversification

We believe that consistent with the current Best Capital Adequacy Ratio (BCAR) methodology for potential property catastrophe loss events, that any adjustment to reported surplus should be based on the higher of a company's 100-year wind net PML, a 250-year earthquake net PML, a recent large loss *or* a potential large surety loss. Inclusion of the largest of the modeled risks in the BCAR calculation would recognize the diversification of such uncorrelated events.

Stochastic Modeling Approach

Unlike the surplus adjustment reflected in the BCAR adjustments for property catastrophe exposures, the proposed deterministic approach to assessing potential surety losses does not consider loss frequency. The consequence is that the proposed loss calculation is significantly more punitive to surplus than corresponding property catastrophe surplus adjustments.

While there are no publicly available loss frequency statistics for the surety industry, it's clear from industry data that surety loss frequency is very low. Due to the relative sophistication and stronger capital base of large contractors, there have been very few cases in particular of large account failures.

Some larger and more sophisticated sureties like Travelers have the scale and data to maintain proprietary credit models as well as utilize public debt default models to assess the frequency of loss within their portfolios. Such frequency assessments, when considered with the SFAA's loss severity study, allow a surety to run stochastic loss simulation models to develop an expected loss distribution for their surety portfolio. Loss distributions allow companies to derive scenarios similar to catastrophe exposure modeling such as 100-year and 250-year events. In the case of Travelers, these tools are an integral part of our portfolio and risk management strategies.

We believe that a company's proprietary stochastically modeled surety PML, when available, could be used in place of the proposed large loss calculation. Specifically, we believe that any BCAR surplus adjustment could be based on a company's 100-year net exposure derived from their stochastic model.

Consideration of Commercial Surety Exposures

While the Exposure Draft includes a brief discussion on Commercial Surety bonds, other than for bail bonds, there appears to be no consideration of a company's large Commercial Surety exposures in the ratings analysis. For many sureties such commercial exposures may in fact be the largest gross and net exposures a company faces. While provisions such as bond duration, cancellation terms and collateral vary materially for such obligations we believe that commercial surety, as well as non-construction contract exposures should also be considered in a surety's assessment of its largest exposures.

Consideration of Multiple Potential Large Losses

For those companies that do not maintain credible stochastic models for their surety portfolios, we believe that the proposed deterministic approach is a reasonable methodology for stress analysis. We believe, however, that considering the extremely low probability of a single loss

occurrence that inclusion of two large surety losses for purposes of a BCAR stress analysis is excessively conservative. This is evidenced by our own stochastic modeling which indicates that Travelers 100-year net Probable Maximum Loss (PML), including both contract and commercial surety bonds, is materially less than the largest potential loss derived through the proposed methodology, let alone including the second largest potential loss.

We believe, in the absence of more sophisticated stochastic modeling, that consideration of a single large loss event for BCAR analysis is adequate, at least for sureties that support the largest construction accounts in the industry. Consideration of multiple events for smaller sureties with limited analytic capabilities and a greater risk of contagion exposure, however, may be prudent.

SFAA Loss Severity Study Factors

Also for those companies that are unable to produce a statistically valid stochastic model for the surety portfolio, we believe that considering both the many loss mitigation strategies that a surety can employ and the historical loss experience of the industry that any surplus and stress calculations should incorporate the more statistically credible 90^{th} percentile PML statistics published by the SFAA. Due to the limited large loss data in the SFAA's study and the simplistic single-factor approach used to extrapolate the 95^{th} percentile factors, there is a much lower level of statistical credibility for 95^{th} percentile PMLs.

Explicit Consideration of Qualitative Factors

The Exposure Draft includes a comprehensive outline of qualitative factors to be considered when assigning a rating to a surety company. Given the significantly varying capabilities of surety companies, and the corresponding implications to financial results, we believe these qualitative factors should be explicitly considered in any reported or stressed BCAR calculations. We believe that this should take the form of a subjective factor reflected in the calculation of potential losses for a surety company.

Business Implications

Increasingly, surety companies face competition from financial institutions that offer products such as bank guarantees and letters of credit as alternatives to surety bonds. Such business tends to be ancillary to the core businesses of a financial institution. As a result pricing as well as terms and conditions for bank guarantee products can be quite aggressive. Our concern is that a ratings methodology that may be more conservative than those imposed on financial intuitions' guarantee businesses, as well as property catastrophe exposure assessments, may put surety companies at a competitive disadvantage in the marketplace. Overly conservative capital requirements for surety companies may create unintended market disruption.

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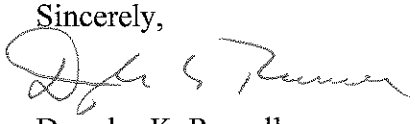
In summary, we support a more tailored approach to surety rating that considers the unique aspects and exposures of the business. We believe that a surety rating methodology that incorporates the above suggestions would help to promote a stronger and more financially stable industry.

Once again, we appreciate your solicitation of feedback on this important ratings matter and the opportunity to comment. If you would like we would be happy to participate in another meeting to further discuss our perspectives on this topic. Thank you again for your consideration of our feedback.

Sincerely,



Douglas K. Russell

Dear Gentlemen:

The SFAA appreciates the opportunity to comment on your revised "Draft: Rating Surety Companies" document published May 1, 2014. Overall, we are very pleased with the evolution of this document since initially published in January of 2013. We have a few recommendations and comments for your consideration:

1. We believe that consistent with the current A.M. Best Capital Adequacy Ratio (BCAR) methodology for potential property catastrophe loss events, that any adjustment to reported surplus should be based on the higher of a company's 100-year wind net PML, a 250-year earthquake net PML, a recent large loss or a potential large surety loss. Inclusion of the largest of the modeled risks in the BCAR calculation would recognize the diversification of such uncorrelated events for larger multi-line P&C carriers.

2. Since the A.M. Best methodology does not consider frequency of loss for a surety portfolio, we believe that considering both the many loss mitigation strategies that a surety can employ and the historical loss experience of the industry that any surplus and stress calculations should incorporate the 90th percentile PML statistics published by the SFAA instead of the 95th.

3. Instead of using a stochastic based model that incorporates both loss severity and frequency to develop a "1 in 100 year event" for a surety portfolio, the most recent A.M. Best draft methodology evaluates the surety's top five principals and uses the two largest net potential losses as part of the surplus evaluation. There are a number of things that need to be considered when determining what the correct metrics are for this type of evaluation. We believe that A.M. Best would have a better indication if it divided the industry into small, medium and large sized surety companies. This would also allow for more peer evaluation creating an "apples to apples" approach. Once divided, we recommend that the number of accounts considered for the stress test should vary by account size. So if the top two accounts represent some of the largest in the industry, which have extremely low frequency of loss, we believe that one account (and not two as in the proposed methodology) is an adequate stress for purposes of analyzing surplus. For the smaller sureties three accounts seem like a more reasonable number and for the medium sureties we recommend a stress of two of the largest accounts.

4. We would like some clarification about how the co-surety percentages will be calculated. We suggest that the limits of all co-sureties should be combined in order to look up the correct PML, which is based on total exposure. In cases where the co-surety percentages vary, the average co-surety percentage for that principal should be used.

5. How will be calculated reinsurance be calculated, especially if the treaty is excess of loss? With excess of loss reinsurance, we recommend that AM Best verify that at least two limits (i.e., at least one reinstatement)

has been purchased. We would like some clarification as to how reinsurance will be represented in the 3rd-5th largest exposure if reinsurance becomes more limited due to aggregate limitations. Because of the remote likelihood of the top five failing, we would suggest that reinsurance be applied at least up to the number of reinstatements for the top two accounts.

6. We would like to get some clarification about how AM Best choose the 40% when assuming that 40% of the reinsurance is not collected and 40% of the net loss is established as a loss reserve by year end.

7. We think that it would be extremely helpful to provide an example of the Stress Test calculation model for inclusion. We are attaching a suggested example for confirmation of understanding. If this is correct, please feel free to use the example.

8. Finally, we suggest you change the nomenclature from "Largest Principals" to "Largest Exposures" when describing the accounts that will be used for the BCAR. The largest principals may not have the greatest exposure, this depends on a principal's use of surety credit and therefore technically the wording could be confusing.

As always, we welcome the opportunity to discuss any of comments made above or any other concerns or issues as they may arise. Thank you for your time and attention.

Best regards,
Joanne

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