AM BEST

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AM Best Responds to Comment Received on Existing Methodology:
"Understanding BCAR for US Property/Casualty Insurers"

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Question:
In the next review, can AM Best please take a look at the Credit Risk component of BCAR for Fronting Carriers. The RDF goes up tremendously. It becomes punitive in terms of doing business with highly rated reinsurers vs. non rated reinsurers (collateralized recoverables). The dispute risk would be much lower for highly rated reinsurers. Secondly, the following treatment for RDF for FH and LOCs & Trusts "(RDF for Unaffiliated – 1)*.75 + 1 " really reduces the benefit of the collateral for BCAR.

Response:
The intent of the reinsurance credit risk factors is to capture the potential risk of non-collection of recoverables due to impairment risk (ability to pay) whereas the intent of the reinsurance dependence factor is to capture the potential risk of non-collection of recoverables, as well as other associated costs, due to dispute risk (willingness to pay).

The BCAR model uses the level of existing recoverables (net of collateral) to PHS to create an initial reinsurance dependence factor, but then looks at existing recoverables (net of collateral) plus ceded written premium as a ratio to PHS to create a forward looking potential level of reinsurance dependence. This forward looking ratio is referred to as Total Ceded Leverage, and when this ratio exceeds 5 times PHS, the model places minimum required capital amounts into the B4 credit risk component. As stated in the criteria, "AM Best increases the overall credit risk charge for their recoverable balances, regardless of underlying credit quality" which makes the model indifferent as to the credit quality of the reinsurers since disputes are a function of the terms and conditions of the reinsurance policies, not the rating of the reinsurers.

The reinsurance dependence factor applied to the collateral was reduced relative to the factor applied to the recoverables themselves because providing collateral to offset impairment risk does not reduce dispute risk. However, in the BCAR model, the multiplicative application of the dependence factor to the recoverables (net of collateral) would result in zero dispute risk being charged for recoverables that were fully collateralized. So in order to capture dispute risk on collateralized recoverables, the reinsurance dependence factor applied to the collateral was reduced from the factor applied to the recoverables themselves.

AM Best does recognize that the minimum thresholds do create higher reinsurance dependence factors for higher rated reinsurers than lower rated reinsurers. Your comment requesting AM Best to review the charge was considered during this year's methodology review. However, no changes pertaining to the reinsurance credit risk factors cited will be made to the model at this time. Thank you for your comment.