PREFACE
2009 EDITION

AN EXPLANATION OF BEST'S CREDIT RATING SYSTEM AND PROCEDURES

SECTION I
INTRODUCTION

Founded in 1899, A.M. Best Company is a global, full-service credit rating agency dedicated to serving the financial and health care service industries. It began assigning credit ratings in 1906, making it the first of today's credit rating agencies to use symbols to differentiate the relative creditworthiness of companies. Within the insurance segment, Best's Credit Ratings cover property/casualty, life, annuity, health, health maintenance organizations (HMOs), reinsurance, captive, and title insurance companies. A.M. Best provides the most comprehensive insurance ratings coverage of any credit rating agency, with reports and ratings maintained on over 10,000 insurance entities worldwide, in approximately 95 countries. A.M. Best is also a well-known and highly regarded source of information and commentary on global insurance trends and issues through a host of other products and services.

A.M. Best's Mission Statement is "To perform a constructive and objective role in serving the insurance marketplace as a source of reliable information and ratings dedicated to encouraging a financially strong industry through the prevention and detection of insurer insolvency." We believe that this proactive role is vital to encourage prudent management of insurance companies and to improve the industry's financial strength for the benefit of policyholders.

Best's Credit Ratings and related financial information provide powerful tools for insurance decision-making and market research for insurance agents, brokers, risk managers, pension managers, employee benefits administrators, investment bankers, insurance executives, policyholders and consumers.

In 1900, A.M. Best first published what became known as *Best's Insurance Reports®—Property/Casualty Edition* which reported on 850 property/casualty insurers operating in the United States. This was soon followed by its companion volume, *Best's Insurance Reports®—Life/Health Edition*, which was published in 1906 reporting on 95 legal reserve life insurers in the United States. For more than a century, these two annual publications have represented the most comprehensive source of financial information on domestic insurers.

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

In 1984, A.M. Best embarked on global coverage of the insurance industry with the publication of *Best's Insurance Reports®—Non-US Edition*, which currently reports, in CD-ROM format, on over 5,800 international property/casualty and life/health companies.

In 1999, A.M. Best expanded its rating assignments to include debt and insurance-linked securities. The issuance of securities ratings for insurers and insurance holding companies is a natural extension of our expertise in providing financial strength ratings and reports on insurance organizations to investors, analysts and policyholders. This focus also serves as the foundation for which ratings are issued to other risk-bearing institutions and entities, including captive insurers and alternative risk transfer facilities.

Within the insurance segment, A.M. Best now assigns ratings to debt securities, surplus notes, preferred stock and hybrid debt instruments, commercial paper, collateralized debt obligations, insurance-based liability or asset-backed securitizations and monetizations, risk-linked securities, closed block securities, and institutional investment products.

In addition to our rating products and services, A.M. Best also publishes a host of other complementary products that are an extension of our knowledge of the industry. Some of these products include *Best's Aggregates and Averages* (industry-wide aggregate totals), *Best's Underwriting Guide* (an underwriter's guide to assessing over 500 commercial risks), and *Best's Loss Control Manual* (a safety engineer's guide to assessing insurance exposures and requirements). These products add to the understanding of the complexities of the insurance industry and enhance our rating evaluations as well as the value and scope of information we provide our subscribers.

A.M. Best currently provides over 50 publications and services to meet the needs of our customers who require timely, accurate and comprehensive information on this dynamic industry. A.M. Best is dedicated to providing our subscribers with the most useful and up-to-date information and ratings available in the insurance industry.

SECTION II

SOURCES OF INFORMATION

The primary source of the information presented in this publication is each insurance company's official annual and quarterly (if available) financial statements as filed with the regulator of the state, province, territory or country in which the company is domiciled. In the United States, most of these financial statements are prepared in accordance with statutory accounting requirements established by the National Association of Insurance Commissioners (NAIC) and administered by the respective states. The Canadian company presentations are in the format prescribed by the Office of the Superintendent of Financial Institutions (OSFI), and some portions of the Canadian data are provided by Beyond 20/20 Inc., Ottawa, Canada.

Our comprehensive review of a company's financial strength is supplemented by publicly available documents, such as Securities and Exchange Commission (SEC) filings in the United States, Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) financial statements. Other sources of information may include audit reports prepared by certified public accountants or actuaries, loss reserve reports prepared by loss reserve specialists, confidential documents provided by company management, our proprietary Background and Supplemental Rating Questionnaires, and annual business plans.

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

Consequently, no representations or warranties are made or given as to the accuracy or completeness of the information presented herein, and no responsibility can be accepted for any error, omission or inaccuracy in our reports. Caution should be used in the interpretation and comparison of the information shown due to the differences which may exist between companies' financial reporting standards, insurance operations, and parent/subsidiary relationships.

SECTION III

OBJECTIVE OF BEST'S CREDIT RATING SYSTEM

Financial Strength Ratings

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

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

An important component of the evaluation process requires an interactive exchange of information with the insurance company's management. As shown in the accompanying table, Best's Financial Strength Ratings range from our highest, A++ (Superior), to our lowest, F (In Liquidation). Companies that subscribe to our interactive rating service are assigned a Best's Credit Rating. A.M. Best may assign Best's Public Data Ratings (noted by the "pd" modifier) to Canadian property/casualty insurers as well as to U.S. health maintenance organizations (HMOs) and health insurers that do not subscribe to our interactive rating process. These Public Data Ratings will be assigned where, in Best's opinion, ratings are needed due to market demand.

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

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

Type of Rating Opinions

	Best's Financial Strength Ratings	
	Interactive	Public Data
Rating Scale	A++ to F	A++ pd to D pd
Evaluation	Quan. & Qual.	Quan. & Qual.
Interaction with Mgmt.	Yes	No
Sufficient Exp. & Size	Yes	Yes

Best's Financial Strength Rating opinions are divided into two broad categories—Secure and Vulnerable. This delineation provides our subscribers with a gauge of how A.M. Best views a company's ability to meet its obligations to policyholders. Based on *Best's Insolvency Studies*, Secure rated companies have experienced a very low rate of failure that is significantly lower than Vulnerable rated companies (and companies unrated or not followed by A.M. Best). Hence, the justification for the two categories.

In Best's opinion, the highest-rated Secure companies have a very strong ability to meet their ongoing obligations to policyholders, while the lowest-rated Secure companies have a good ability. The time frame for the ability of Secure companies to meet their current and ongoing obligations to policyholders varies. The higher a company's Secure rating, the greater its ability to withstand adverse changes in underwriting and economic conditions over longer periods of time. The time frame in which Vulnerable companies are expected to meet their obligations also varies. "Fair," "Marginal" and "Weak" rated companies may only have a current ability to pay claims, while companies rated "Poor," "Under Regulatory Supervision" and "In Liquidation" may not have an ability to fully meet their current obligations to policyholders.

Issuer Credit Ratings and Debt Ratings

A.M. Best also assigns Issuer Credit Ratings (ICR) and Debt Ratings to insurance operating companies and holding companies and securities issued by these entities. While our annual publications include only Financial Strength Ratings, Issuer Credit Ratings and Debt Ratings can be found along with Financial Strength Ratings on the A.M. Best Web site, www.ambest.com.

A Best's Debt/Issuer Credit Rating is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

A Best's Long-Term Issuer Credit Rating is an opinion of an issuer/entity's ability to meet its ongoing senior financial obligations. These ratings are assigned to insurance companies, holding companies or other legal entities authorized to issue financial obligations.

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

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

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

SECTION IV

BEST'S CREDIT RATING SCALE

The Best's Financial Strength Rating scale is comprised of 16 individual ratings grouped into 10 categories, consisting of three **Secure** categories of "Superior," "Excellent" and "Good" and seven **Vulnerable** categories of "Fair," "Marginal," "Weak," "Poor," "Under Regulatory Supervision," "In Liquidation" and "Rating Suspended."

Financial Strength Ratings

Secure

A++ and A+ **(Superior)**
Assigned to companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.

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

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

Vulnerable

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

C++ and C+ **(Marginal)**
Assigned to companies that have, in our opinion, a marginal ability to meet their ongoing insurance obligations, but are financially vulnerable to adverse changes in underwriting and economic conditions.

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

D **(Poor)**
Assigned to companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations and are financially extremely vulnerable to adverse changes in underwriting and economic conditions.

E **(Under Regulatory Supervision)**
Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by an insurance regulatory authority under a significant form of supervision, control or restraint whereby they are no longer allowed to conduct normal, ongoing insurance operations. This would include conservatorship or rehabilitation, but does not include liquidation. It may also be assigned to companies issued cease and desist orders by regulators outside their home state or country.

F **(In Liquidation)**
Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company. Note: Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.

S **(Rating Suspended)**
Assigned to rated companies that have experienced sudden and significant events affecting their balance sheet strength or operating performance whereby the rating implications cannot be evaluated due to a lack of timely or adequate information.

Best's Long-Term Issuer Credit Ratings and Long-Term Debt Ratings

Best's Long-Term Issuer Credit Rating and Long-Term Debt Rating scale is comprised of 22 individual ratings grouped into 8 categories, consisting of four **Investment Grade** categories of "Exceptional," "Very Strong," "Strong" and "Adequate" and four **Non-Investment Grade** categories of "Speculative," "Very Speculative," "Extremely Speculative" and "In Default."

Investment Grade

aaa **(Exceptional)**
Assigned to issues where, in our opinion, the issuer has an exceptional ability to meet the terms of the obligation.

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

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

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

Non-Investment Grade

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

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

ccc+ and **ccc** and **ccc-** and **cc** and **c** **(Extremely Speculative)**
Assigned to issues where, in our opinion, the issuer has extremely speculative credit characteristics, generally due to a minimal margin of principal and interest payment protection and extreme vulnerability to economic changes.

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

While the above definitions apply to entities which do not issue insurance obligations, A.M. Best also assigns Issuer Credit Ratings to all rated insurance companies. In addition, it should also be noted that A.M. Best assigns Issuer Credit Ratings to publicly traded holding companies, where a significant portion of cash flow is provided by insurance operations. The definitions applied to insurance companies that are assigned an Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Good; (bb) - Fair; (b) - Marginal; (ccc, cc) - Weak; (c) - Poor; (rs) - Regulatory Supervision/Liquidation.

Best's Short-Term Issuer Credit Ratings and Short-Term Debt Ratings

Best's Short-Term Issuer Credit Rating and Short-Term Debt Rating scale is comprised of 6 individual ratings grouped into 6 categories, consisting of four **Investment Grade** categories of "Strongest," "Outstanding," "Satisfactory" and "Adequate" and two **Non-Investment Grade** categories of "Speculative" and "In Default."

Investment Grade

AMB-1+ **(Strongest)**
Assigned to issues where, in our opinion, the issuer has the strongest ability to repay short-term debt obligations.

AMB-1 **(Outstanding)**
Assigned to issues where, in our opinion, the issuer has an outstanding ability to repay short-term debt obligations.

AMB-2 **(Satisfactory)**
Assigned to issues where, in our opinion, the issuer has a satisfactory ability to repay short-term debt obligations.

AMB-3 **(Adequate)**
Assigned to issues where, in our opinion, the issuer has an adequate ability to repay short-term debt obligations; however, adverse economic conditions will likely reduce the issuer's capacity to meet its financial commitments.

Non-Investment Grade

AMB-4 **(Speculative)**
Assigned to issues where, in our opinion, the issuer has speculative credit characteristics and is vulnerable to adverse economic or other external changes, which could have a marked impact on the company's ability to meet its financial commitments.

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

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

SECTION V

RELEASE OF FINANCIAL STRENGTH RATINGS

Best's rating opinions are formally evaluated at least once every 12 months. The annual review is based on comprehensive information provided to A.M. Best, which includes annual and quarterly (if available) financial statutory statements filed with regulators and SEC filings (if applicable), together with other publicly available financial statements prepared under GAAP or IFRS standards and confidential documents including Best's Supplemental Rating Questionnaires (for interactive Best's Credit Ratings).

With our interactive Best's Credit Ratings, analysts maintain rating contact with company management throughout the year and monitor each company's performance. Ratings are continually re-evaluated for changes that might arise during the year, or in conjunction with our ongoing dialogue with company management.

Ratings are reviewed and released throughout the year following a formal annual review, including upgrades, downgrades, affirmations, new assignments or ratings placed under review (see section X, Affiliation Codes and Rating Modifiers). In addition, all ratings are reviewed following the receipt of the annual financial statements, as well as quarterly filings to ensure there have been no material changes since the last formal rating review. Moreover, due to event-driven circumstances, rating actions may be released outside of the scheduled formal review process. Situations such as mergers or acquisitions, dramatic changes in financial information, legislative/regulatory actions or current events are examples of occasions that may instigate a rating action or change. Best's Credit Ratings are updated and are released as soon as practicable through *Best's Internet Service* via www.ambest.com—A.M. Best's Web site. Rating upgrades and downgrades, as well as initial ratings are also released through Best's Rating Actions in *BestWeek®*, our most timely and complete release of ratings in print. Selected rating changes and new ratings are published on a monthly basis in *Best's Review®*, our monthly magazine. Finally, updated *AMB Credit Reports - Insurance Professional (Unabridged)* are available shortly after the publication of a company's updated rating assignment and following the review of the company's annual statutory statement.

Rating Outlooks

A rating outlook indicates the potential future direction of a company's rating over an intermediate period, generally defined as the next 12 to 36 months. Rating outlooks can be positive, negative or stable. A positive outlook indicates that a company is experiencing favorable financial and market trends, relative to its current rating level. If these trends continue, the company has a good possibility of having its rating upgraded. A negative outlook indicates that a company is experiencing unfavorable financial and market trends, relative to its current rating level. If these trends continue, the company has a good possibility of having its rating downgraded. A stable outlook indicates that a company is experiencing stable financial and market trends, and that there is a low likelihood the company's rating will change over an intermediate period. Positive or negative outlooks do not necessarily lead to a change in a company's rating. Similarly, a stable rating outlook does not preclude a rating upgrade or downgrade. Rating outlooks appear immediately following the Rating Rationale section of the company's *AMB Credit Report.*

Rating History

To enable the reader to track trends, *Best's Insurance Reports* contains a Five Year History section and *Best's Key Rating Guide* presents the five latest rating events.

SECTION VI

ASSIGNMENT OF BEST'S CREDIT RATINGS

The assignment of an interactive Best's Financial Strength Rating (A++ to F) involves a comprehensive quantitative and qualitative analysis of a company's **balance sheet strength**, **operating performance** and **business profile**.

For our interactive Best's Financial Strength Ratings, we believe this balanced method of evaluating a company on both quantitative and qualitative levels provides a better insight of a company and results in a more discerning and credible rating opinion.

The interpretation of quantitative measurements involves the incorporation of more qualitative considerations into the process that may impact prospective financial strength. Our quantitative evaluation is based on an analysis of each company's reported financial performance, utilizing over 100 key financial tests and supporting data. These tests, which underlie our evaluation of balance sheet strength and operating performance, vary in importance depending upon a company's characteristics.

In assigning a Best's Financial Strength Rating, additional consideration is given to balance sheet strength for those companies that are exposed to shorter-duration liabilities (less than 2-3 years) or those companies maintaining extremely strong balance sheet strength. Companies exposed to short-duration liabilities face fewer unknown losses, reducing long-term risk. Alternatively, those companies exposed to long-duration liabilities (over 7 years) face greater uncertainty and risk, and more importance is placed on operating performance, which will need to be strong to sustain or enhance balance sheet strength over the long term. Those companies with an extremely strong balance sheet are given additional consideration while improving their weak profitability.

A company's quantitative results are compared with industry composites as established by A.M. Best. Composite standards are based on the performance of many insurance companies with comparable business mix and organizational structure. In addition, industry composite benchmarks are adjusted from time to time for systemic changes in underwriting, economic and regulatory market conditions to ensure the most effective and appropriate analysis.

Risk Management

An important aspect of any insurance company operation, risk management is the process by which companies systematically identify, measure and manage the various types of risk inherent within their operations. The fundamental objectives of a sound risk management program are to manage the organization's exposure to potential earnings and capital volatility, and maximize value to the organization's various stakeholders. Enterprise Risk Management (ERM) has grown in importance as companies consider the correlation of many risks that they have historically managed independently, or deal with emerging risk issues inherent in many of today's more sophisticated product offerings.

The analysis of ERM is an integral part of the rating analysis and discussions with all rated companies. A company's risk management capabilities are considered in the qualitative assessment of all three rating areas: balance sheet strength, operating performance, and business profile.

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

Group Ratings

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

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

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

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

A.M. Best uses its consolidated view of the organization to conduct an enterprise-level analysis. This determines the highest possible rating for the lead insurer within the group, accounting for strengths and weaknesses that may reside not only within the insurance entities but also at the holding company or at a non-insurance affiliate. With this information, A.M. Best determines whether or not the individual insurance subsidiaries qualify for enhancement or drag to their stand-alone ratings.

Parent/Subsidiary Relationships

The implicit or explicit support of a parent or affiliate can affect an insurer's financial strength and therefore its Best's Credit Rating. The assessment of support involves a top-down, bottom-up analysis of the parent organization and each subsidiary. This analysis enables A.M. Best to classify a company in one of three categories from which its stand-alone rating will receive full rating enhancement, partial rating enhancement or no rating enhancement.

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

Rating Start-up Insurers

Start-ups rated by A.M. Best are subject to the same assessment of balance sheet strength and business profile as established companies receiving an interactive rating assignment. However, because these new entities have yet to demonstrate a track record in operating performance, Best also applies a stringent set of qualitative standards upon which initial ratings may be issued.

Some of the more specific considerations utilized by A.M. Best in assigning ratings to start-up insurers/reinsurers are broken down into four critical areas: management, sponsorship, strategy, and capitalization. However, in addition to these factors, certain conditions must be present, transcending all other rating considerations for Best to proceed with an initial rating assignment.

- Initial financing either must be in place or must be expected to be executed prior to the initial rating assignment.
- Appropriate management, staff and operational infrastructure must be available to support initial activities.
- A follow-up process to review the execution of the initial business plan, along with a formal process to monitor the company's strategic and financial development, must be agreed to by A.M. Best and company management.
- Stress-tested capitalization must conservatively support the assigned rating throughout the business plan.

SECTION VII

BALANCE SHEET STRENGTH

In determining a company's ability to meet its current and ongoing senior obligations, the most important area to evaluate is its balance sheet strength. An analysis of a company's **underwriting, financial, operating** and **asset leverage** is very important in assessing its overall balance sheet strength.

Balance sheet strength measures the exposure of a company's surplus to its operating and financial practices. A highly leveraged, or poorly capitalized company can show a high return on equity/surplus, but may be exposed to a high risk of instability. Conservative leverage or capitalization enables an insurer to better withstand catastrophes, unexpected losses and adverse changes in underwriting results, fluctuating investment returns or investment losses, and changes in regulatory or economic conditions.

Underwriting leverage is generated from three sources: current premium writings, reinsurance recoverables and loss or policy reserves. A.M. Best reviews these forms of leverage to analyze changes in trends and magnitudes. To measure a company's exposure to pricing errors in its book of business, we review the ratio of gross and net premiums written to capital. To measure the company's credit exposure and dependence on reinsurance, we review the credit quality of a company's reinsurers and ratio of reinsurance premiums and reserves ceded and related reinsurance recoverables to surplus. To measure the company's exposure to unpaid obligations, unearned premiums and exposure to reserving errors, we analyze the ratio of net liabilities to surplus.

In order to assess whether or not a company's underwriting leverage is prudent, a number of factors unique to the company are taken into consideration. These factors include type of business written, spread of risk, quality and appropriateness of its reinsurance program, quality and diversification of assets, and adequacy of loss reserves.

A.M. Best reviews a company's **financial leverage** in conjunction with its underwriting leverage in forming an overall opinion of a company's balance sheet strength. Financial leverage through debt, or debt-like instruments (including financial reinsurance), may place a call on an insurer's earnings and strain its cash flow. Similar to underwriting leverage, excessive financial leverage at the operating or holding company can lead to financial instability. As such, the analysis of financial leverage is conducted both at the operating company and holding company levels, if applicable.

To supplement its assessment of financial leverage, A.M. Best also reviews a company's **operating leverage**. A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on an insurer's earnings and cash flow. In other words, the residual risk to the insurer would be insignificant as long as the insurer possesses sound asset/liability, liquidity and investment risk management capabilities; exhibits low duration mismatches; and minimizes repayment and liquidity risk relative to these obligations. Best has established specific tolerances for operating leverage activities that are applied at each operating company, as well as at the consolidated level. Generally, debt obligations viewed by A.M. Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

A.M. Best also evaluates **asset leverage**, which measures the exposure of a company's surplus to investment, interest rate and credit risks. Investment and interest rate risks measure the credit quality and volatility associated with the company's investment portfolio and the potential impact on its balance sheet strength.

A company's underwriting, financial and asset leverage is also subjected to an evaluation by Best's Capital Adequacy Ratio (BCAR), which calculates the Net Required Capital to support the financial risks of the company associated with the exposure of its investments, assets and underwriting to adverse economic and market conditions such as a rise in interest rates, decline in the equity markets and above-normal catastrophes. This integrated stress analysis evaluation permits a more discerning view of a company's balance sheet strength relative to its operating risks. The BCAR is based on audited financial statements and supplemental information provided by companies. A company's BCAR result is useful in determining a company's balance sheet strength. A.M. Best also views insurance groups on a consolidated basis and assigns a common BCAR result to group consolidations or multiple member companies that are linked together through intercompany pooling or reinsurance arrangements.

A.M. Best recognizes that risk management tools and practices across the insurance industry have advanced significantly in recent years. Developments such as the implementation of ERM programs, including economic capital models, more sophisticated catastrophe management, and dynamic hedging programs have headlined efforts of the insurance industry to manage its growing exposure to potential earnings and capital volatility.

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

Capitalization Tests:

• **Change in Net Premiums Written (NPW):** A company should demonstrate an ability to support controlled business growth with quality surplus growth from strong internal capital generation.

• **NPW to Policyholders' Surplus (PHS):** This ratio measures a company's net retained premium in relation to its surplus. This ratio measures the company's exposure to pricing errors in its current book of business.

• **Net Liabilities to PHS:** This ratio measures a company's exposures to errors of estimation in its loss reserves and all other liabilities. The higher the loss reserve leverage the more critical a company's solvency depends upon having and maintaining adequate reserve levels.

• **Net Leverage:** This ratio measures the combination of a company'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 surplus.

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

• **Gross Leverage:** This ratio measures a company's gross exposure to pricing errors in its current book of business, to errors of estimating its liabilities, and exposure to its reinsurers.

• **Best's Capital Adequacy Ratio (BCAR):** The BCAR compares an insurer's adjusted surplus relative to the required capital necessary to support its operating and investment risks. Companies deemed to have "adequate" balance sheet strength normally generate a BCAR score of over 100% and will usually carry a Secure Best's Credit Rating. However, the level of capital required to support a given rating level varies by company, depending on its operating performance and business profile.

Adjusted surplus is reported surplus plus/minus adjustments made to provide a more comparable basis for evaluating balance sheet strength. Such modifications include adjustments related to equity in unearned premiums, loss reserves, and assets. Certain off-balance sheet items are also deducted from reported surplus, such as encumbered capital, debt service requirements, potential catastrophe losses and future operating losses.

Net Required Capital is calculated as the necessary level of capital to support seven broad risk categories, including B1 (Fixed Income Securities); B2 (Equity Securities); B3 (Interest Rate); B4 (Credit); B5 (Loss and Loss Adjustment Expense [LAE] Reserves); B6 (Net Premiums Written); and B7 (Business Risk). Net Required Capital represents the arithmetic sum of capital required to support each of the risk categories reduced by a covariance adjustment. The covariance adjustment reduces a company's total capital requirement by recognizing that risks associated with many of the seven categories are independent and do not occur at the same time.

Generally, over two-thirds of a property/casualty company's net capital requirement is generated from its B5 (Loss and LAE Reserves) and B6 (Net Premiums Written) risk components, which are influenced by a company's 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 company's net capital requirement is generated by C1 (Credit Risk) and C3 (Interest Rate Risk).

Natural Catastrophe Stress Test

In addition to requiring a company to maintain capitalization that can withstand the net, after tax, impact to surplus from a reasonably severe natural catastrophe, A.M. Best performs a stress test on the capitalization of a property/casualty insurer by adjusting BCAR to reflect the company's stressed risk profile shortly following the occurrence of a catastrophic event. The company's stressed risk profile includes reductions to surplus for incurred loss and LAE and the cost of reinstatement premiums, increases to reinsurance recoverables and net loss reserves, and a charge to surplus for the company's exposure to a subsequent event. This analysis provides a preview of a company's balance sheet strength as if the event actually occurred, and reflects the notion that the company's exposure remains essentially the same after the event as it was on the day of the event.

The amount of tolerance afforded to the deterioration in BCAR will be determined based on a number of quantitative and qualitative factors. As part of this analysis, a company's overall catastrophe risk management process is evaluated and considered along with the financial flexibility of a company to determine its ability to avoid a material loss to capital, and to respond to any significant capital deterioration from such events. Companies that demonstrate strength in both of these areas will be afforded the greatest amount of flexibility within A.M. Best's stress test of catastrophe exposure.

A.M. Best believes the keys to strong catastrophe risk management are ensuring data quality in terms of the integrity, completeness and timeliness of the data collected; monitoring aggregate and potential loss exposures on a frequent and consistent basis; and implementing controls that establish acceptable levels of exposure and integrate catastrophe management into the underwriting process.

Other important considerations include a company's exposure to multiple events in a season, historical volatility of operating performance or balance sheet strength, the overall level of catastrophe exposure to surplus on both a gross and net basis, the capital markets' willingness to provide funding, and the type of funding available.

Terrorism Risk

Despite the complexities in identifying, monitoring, quantifying and managing terrorism risks, A.M. Best believes that a comprehensive terrorism risk management process is crucial to the financial strength rating of any insurer with a material exposure to terrorism risk. A.M. Best's key concerns are the organization's aggregate exposure to terrorism, the number of insured locations, the geographic concentration of insured exposures, the impact on capitalization, and the uncertainty surrounding a government's long-term commitment to a federal backstop. Although a federal backstop can help reduce the impact of terrorism losses, reliance on such a mechanism cannot replace a sound risk management process.

For insurers with a material exposure to terrorism loss, a charge to surplus will be calculated that reflects the probability of a large-scale attack, the location of the attack, the number of large exposure concentrations, the size of the exposures, the level of detail in the coding of exposures, and any offsets to the direct loss. These offsets include recoveries from reinsurance, protection from federal backstops and a federal tax offset. The terrorism charge will be compared with the insurer's natural catastrophe probable maximum loss (PML), and the larger of the two charges will be used in the evaluation of the insurer's balance sheet strength. In addition, insurers will be subject to a terrorism stress test, which quantifies the impact that a large-scale attack could have on an insurer's balance sheet strength if the protection from the federal backstop is not available.

Finally, A.M. Best will review the insurer's strategy, risk tolerance, underwriting guidelines, and mitigation methods. The level of detail and the frequency of the monitoring of its geographic concentrations and exposure to various types of attacks also will be factored into the evaluation of the insurer's financial strength.

Capital Structure/Holding Company

Holding companies (if present) and their associated capital structures can have a significant impact on the overall financial strength of an insurance company subsidiary. Holding companies can provide subsidiaries with a level of financial flexibility, including capital infusions, access to capital markets, and in some cases, additional cash flow sources from other operations. Likewise, debt and other securities are typically obligations of a holding company which, depending on the magnitude of these obligations, can reduce the financial flexibility of the enterprise and potentially place a strain on future earnings and inhibit surplus growth at a subsidiary.

A.M. Best reviews both an insurer's capital structure and its holding company's capital structure to determine if they are sound and unencumbered. This review includes an assessment of the quality of capital with a focus on the amount, composition, and amortization schedule of intangible assets as well as the presence of surplus notes at the operating company.

A holding company can have various types of financial instruments, including debt securities, preferred stocks or other hybrid securities in its capital structure. For mutual companies, surplus notes can exist as a component of overall surplus. A.M. Best reviews the relative debt and equity characteristics of a particular capital security in determining overall financial leverage. Our review focuses on specific terms and features of securities, including the coupon and dividend rate, repayment terms and financial and other covenants. Insurance subsidiaries generally fund debt service and other obligations of their holding company through a combination of dividends, tax-sharing payments and other expense allocation agreements with their holding company. As such, A.M. Best measures the extent to which an insurance company's earnings or the holding company's cash flow can cover interest and other fixed obligations.

Integral to an insurer's rating assignment is our assessment of a company's ability to meet the debt service and other obligations associated with its parent's capital structure and the risks that a capital structure imposes on a company.

Additionally, Best employs a top-down view of the total organization that includes a review of the non-insurance operations of a holding company, to determine their impact, if any, on the overall financial strength of the insurance operations.

Quality and Appropriateness of Reinsurance and Other Risk Mitigation Programs

Reinsurance plays an essential role in the risk-spreading process and provides insurers with varying degrees of financial stability. As a result, we evaluate a company's reinsurance program to determine its appropriateness and credit quality. A company's reinsurance program should be appropriate relative to its policy limits and underwriting risks, catastrophe exposures, business, financial capacity and 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 company from impairment or insolvency, from large shock-losses such as a 100-year wind storm, a 250-year earthquake, or its annual aggregate loss exposure. In addition, reinsurance should also provide protection from a series of smaller storm losses that do not trigger recovery from a traditional catastrophe reinsurance program. In addition to spreading risk, reinsurance can be utilized to leverage a company's surplus to enable it to write more business than would otherwise be possible.

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

Sidecars are yet another way for insurers/reinsurers to mitigate risk. A sidecar is a limited-life, special-purpose reinsurance vehicle that generally provides property catastrophe quota-share reinsurance exclusively to its sponsor. Sponsors of sidecars generally take reinsurance credit for transferring risks to sidecars. While some sidecars may be capitalized to full aggregate limits, others may not be adequately capitalized to absorb losses that deviate from expectations. When capitalization is inadequate, some of the risk originally assumed to be fully hedged by a sidecar (in the determination of the Best's FSR of the sponsor) ultimately may be borne by the sponsor. This risk is referred to as "tail risk." A.M. Best's analysts will assess tail risk to ensure that the appropriate reinsurance credit is given to the sponsor of a sidecar.

For life/health companies, a reliable reinsurance program must consider sound risk management practices to provide the company with protection against adverse fluctuations in experience. Since these risk transfer agreements on an underlying policy or policies indemnify the company for insurance risks, prudent evaluation of the economic impact on a company's life, health, and annuity operations is critical. Incorporating reinsurance to manage a company's financial risk that includes mortality, morbidity, lapse or surrender, expense, and investment performance presents a competitive risk to a counterparty’s future growth prospects and long-term viability. Therefore, the range of reinsurance must be evaluated with the company's ability to manage its growth relative to demands for life and health insurance coverages under existing economic and regulatory environments.

An insurer's ability to meet its financial obligations can become overly dependent upon the performance of its reinsurers. A company can also become exposed to the state of reinsurance markets in general. A significant dependency on reinsurance can become problematic if a major reinsurer of the company becomes insolvent or disputes coverage for claims. It also can become a problem if general reinsurance rates, capacity, terms and conditions change dramatically following an industry event. The more a company is dependent upon reinsurance, the more vulnerable its underwriting capacity becomes to adverse changes in the reinsurance market. The greater this dependency, the greater our scrutiny of a company's reinsurance program to determine its appropriateness and credit quality and whether it is temporary or permanent in nature.

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

These transactions impact a company's financial strength as measured by the BCAR calculation, and also impact a company's operating leverage. By ceding reserves to a captive company, the direct insurer's insurance risk is reduced on the BCAR. However, the captive is typically more thinly capitalized than the direct writer for these reserves (though within regulatory guidelines), and the capital structure is typically supported primarily through surplus notes, not equity contribution. Additionally, the transfer of the reserves from the direct writer's balance sheet reduces surplus strain, freeing the company to write even more business. These various factors are considered in evaluating the appropriateness of the insurer's overall reinsurance and risk mitigation program.

Adequacy of Loss/Policy Reserves

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 U.S. property/casualty companies, we evaluate reserving trends through our proprietary loss reserve model to measure any equity imbedded in a company's loss reserves. Upon determining our 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 sizeable for property/casualty insurers, enables A.M. Best to "level the playing field" within our rating evaluation and better discriminate between companies that historically have underreserved from those that have strong loss reserve positions.

Separately, we also evaluate a company's ability to monitor premium adequacy and the degree of uncertainty in loss reserves. If the level of reserve uncertainty exceeds any equity in the reserves, or is considered large in relation to net income and surplus, we will require a company to maintain a more conservative capital position (i.e., BCAR score) for its rating level. Loss reserve uncertainty and earnings drag are most pronounced in the area of asbestos and environmental (A&E), and to a lesser extent, other emerging mass tort exposures.

We use both public and non-public reserve and paid loss data in calculating several crude benchmarks to identify companies that may have a material exposure to A&E liabilities. Best's A&E analysis focuses on earnings and surplus drag associated with a company's potential unfunded liabilities. These unfunded liabilities are calculated relative to a company's market share of Best's industry-wide estimate for total A&E costs less the company's cumulative incurred losses recognized to date. Best's initial analysis also focuses on a company's relative funding status as measured by its survival ratio (reserves to recent paid losses) against prevailing industry levels.

Casualty insurers that appear underfunded through Best's benchmarking analysis, receive significantly greater ratings scrutiny. For these insurers, we require more detailed information related to their A&E claim trends, policies exposed, reserving practices, and claims mitigation efforts, as well as their estimation of their ultimate liability through ground-up modeling.

For companies with sizeable exposure to A&E claims, A.M. Best requires these companies to perform appropriate ground-up A&E policy-by-policy exposure analysis to more accurately determine their funding requirements for their ultimate A&E liabilities. Best believes that increased enhancements to, and market acceptance of, ground-up modeling are very important for a company to prudently manage its A&E liability exposures.

Key Loss Reserve Tests:

• **Loss and LAE Reserves to PHS:** 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 PHS:** This ratio reflects the degree to which year-end surplus was either overstated (+) or understated (-) in each of the past several years.

• **Developed to NPE:** 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.

Quality and Diversification of Assets

The quality and diversification of assets contribute to a company's financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) are evaluated to assess the risk of default and the potential impact on surplus if the sale of these assets occurred unexpectedly. The higher the liquidity, diversification and/or quality of the asset portfolio the less uncertainty there is in the value to be realized upon an asset sale and the lesser the likelihood of default. Therefore, a company's investment portfolio guidelines are reviewed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large single investments that exceed 10% of a company's total capital. Companies that hold illiquid, undiversified and/or speculative assets and have a significant underwriting exposure to volatile lines of business that are vulnerable to unfavorable changes in underwriting and/or economic conditions can jeopardize policyholders' surplus.

Liquidity

Liquidity measures a company's ability to meet its anticipated short- and long-term obligations to policyholders and other creditors. A company's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diversified and liquid or through operating cash flow. A high degree of liquidity enables an insurer to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

To measure a company's ability to satisfy its financial obligations without having to resort to selling long-term investments or affiliated assets, we review a company's quick liquidity, which measures the amount of cash and quickly convertible investments that have a low exposure to fluctuations in market value. We also review current liquidity to measure the proportion of a company's total liabilities that are covered by cash and unaffiliated invested assets. Operational and net cash flows are reviewed since they, by themselves, can meet some liquidity needs provided cash flows are positive, large and stable relative to cash requirements. Finally, we evaluate the quality, market value and diversification of assets, particularly the exposure of large single investments relative to capital.

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 company's ability to settle its outstanding liabilities without prematurely selling long-term investments or to borrow money.

• **Current Liquidity:** This ratio measures the proportion of liabilities covered by unencumbered cash and unaffiliated investments. If this ratio is less than 100, the company'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 company'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 company'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.

• **Class 3-6 Bonds to PHS:** This test measures exposure to non-investment grade bonds as a percentage of surplus. Generally, non-investment grade bonds carry higher default and illiquidity risks.

SECTION VIII

OPERATING PERFORMANCE

Profitability

Profitable insurance operations are essential for a company to operate as an ongoing concern. For an insurer to remain viable in the marketplace, it must perpetuate a financially strong balance sheet for its policyholders. When evaluating operating performance, Best's analysis centers on the stability and sustainability of the company's sources of earnings in relation to the liabilities that are retained by the company. Since long-term balance sheet strength is generally driven by operating performance, greater importance is placed on operating performance when evaluating insurers writing long-duration business. Conversely, operating performance is weighted less heavily for those insurers writing predominantly short-duration business that also possess very strong capitalization and a stable business profile.

A.M. Best reviews the components of a company's statutory earnings over the past five-year period to make an evaluation of the sources of profits and the degree and trend of various profitability measures. Areas reviewed include underwriting, investments, capital gains/losses and total operating earnings, both before and after taxes. Profitability measures are easily distorted by operational changes; therefore, we review the mix and trends of premium volume, investment income, net income and surplus. Also important to evaluating profitability is the structure of the company (stock vs. mutual), the length and nature of its insurance liability risks and how these elements relate to the company's operating mission. The degree of volatility in a company's earnings and the impact that this could have on capitalization and balance sheet strength is of particular interest to A.M. Best.

To supplement our review of profitability, A.M. Best analyzes the company's earnings on a GAAP basis, IFRS basis, and any other regulatory or accounting reporting in order to understand the company's forms and measurements of profitability. This review generally extends beyond the scope of publicly traded companies since an increasing number of non-public insurers also prepare, monitor and/or manage to GAAP, IFRS or other forms of accounting reporting. Best recognizes that a proper assessment of an insurer's current and prospective profitability may involve a review of multiple accounting forms and results to ascertain the true economic picture.

Key Profitability Tests:

• **Loss Ratio:** This ratio measures the company's underlying profitability, or loss experience, on its total book of business.

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

• **Combined Ratio after Policyholder Dividends:** This ratio measures the company's overall underwriting profitability. A combined ratio of less than 100 indicates the company has reported an underwriting profit.

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

• **Pretax ROR (Return on Revenue):** This ratio measures a company'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 company's invested assets before capital gains/losses and income taxes.

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

• **Return on PHS:** This ratio measures a company'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 activities, including unrealized capital gains.

SECTION IX

BUSINESS PROFILE

Business Profile Issues

Business profile can be an important component of Best's rating evaluation. The factors that comprise an insurer's business profile drive current and future operating performance and, in turn, can impact long-term financial strength and the company's ability to meet its obligations to policyholders.

Business profile is influenced by the degree of risk inherent in the company's mix of business, an insurer's competitive market position and the depth and experience of its management. Lack of size or growth are not considered negative rating factors unless A.M. Best believes these issues have a negative influence on the company's prospective operating performance and balance sheet strength.

A.M. Best places greater emphasis on business profile issues for insurers writing long-duration business, such as life, retirement savings, casualty lines, and reinsurance where long-term financial strength is critical. Conversely, less business profile emphasis is placed on auto and property writers as well as indemnity health insurers writing shorter-duration contracts where short- to medium-term financial strength is of greater importance.

In addition, business profile issues increase in their importance at Best's highest rating levels. At the "Superior" level, insurers are expected to have strong balance sheets and operating performance, and exhibit stable operating trends. What differentiates these companies is the strength of their business profile, which typically translates into defensible competitive advantages. This rating approach is consistent with the requirements of today's marketplace, which is concerned with an insurer's financial strength and market viability.

Key Business Profile Issues

• **Spread of Risk:** A company's book of business must be analyzed by line in terms of its geographic, product and distribution diversification. However, the size of a company, measured solely by its premium volume, cannot be used to judge its spread of risk.

Generally, large companies have a natural spread of risk. Similarly, a small company, which is conservatively managed, writes conservative lines of business and avoids a concentration of risk, can attain the same degree of stability in its book of business as that experienced by a large company, with the exception of regulatory or residual market risks.

For property/casualty companies, the geographic location and concentration of a book of business can have a great impact upon its exposure to catastrophic losses, such as terrorist attacks, hurricanes, tornadoes, wind storms, hail or earthquakes. For property insurers, Best requires a company to perform some degree of natural catastrophe modeling on its book of business.

Property insurers with potential exposures that have never performed weather and earthquake catastrophe modeling are effectively required to do so in order to qualify for Best's Secure ratings (A++ to B+). Best believes that natural catastrophe modeling is critical and plays an important role in prudently managing property exposures. Best gathers catastrophe exposure and related reinsurance protection data through its Supplemental Rating Questionnaire.

The geographic location and lines of business written by a company also determine its exposure or vulnerability to regulatory or residual market risks that exist within certain jurisdictions. In addition, the mix of business must also be carefully evaluated. Because the underwriting experience between lines of business varies dramatically, the underwriting risk profile of a company must be determined since high-risk lines with volatile loss experience can impact the financial stability of an insurer, particularly one that is poorly capitalized and/or has poor liquidity.

• **Revenue Composition:** A by-line analysis of net premium volume is important to determine changes in the amount, type, geographic distribution, diversification and volatility of business written by a company, which can either have a beneficial or adverse effect on its prospective profitability. Underwriting income, investment income, capital gains, asset values and, consequently, surplus can be significantly affected by external changes in economic, regulatory, legal and financial market environments, as well as by natural and man-made catastrophes.

• **Competitive Market Position:** Analysis of an insurer's operating strategy and competitive advantages by line is essential to assess a company's ability to respond to competitive market challenges, economic volatility and regulatory change in relation to its book of business. Defensible and sustainable competitive advantages include control over distribution, multiple distribution channels, a low-cost structure, effective utilization and leveraging of technology, superior service, strong franchise recognition, a captive market of insureds, easy and inexpensive access to capital, and underwriting expertise within the book of business.

• **Management:** The experience and depth of management are important determinants for achieving success. Because the insurance business is based on an underlying foundation of trust and fiscal responsibility, prudent management plays a more vital role than in most other industries.

Competitive pressures within virtually every insurance market segment have amplified the importance of management's ability to develop and execute defensible strategic plans. Best's understanding of the operating objectives of a company's management team plays an important role in its qualitative evaluation of the current and future operating performance of a company. This is particularly true when a company is undergoing a restructuring to address operational issues, balance sheet problems or is actively raising capital.

• **Insurance Market Risk:** Insurance market risk reflects the potential financial volatility that is introduced by, and associated with, the segment(s) of the insurance industry and/or the financial services sphere within which an organization operates. Such risks may also be considered systemic risks and are generally common to all market participants (i.e., financial services reform, health care reform, expansion of alternative markets, and integration of health care providers). Insurance market risk can be biased either positively or negatively by a number of company-specific business factors.

• **Event Risk:** Event risk can encompass a variety of sudden or unexpected circumstances that may arise and can potentially impact an insurer's financial strength and its Best's Credit Rating. When a sudden or unexpected event occurs, we evaluate the financial and market impact to the insurer. For example, the potential exists for major business and distribution disruption associated with significant litigation, the potential for a "run-on-the-bank" due to a loss of policyholder/distributor confidence, economic collapse or the enactment of significant legislation. In addition, constraints imposed by regulators in the form of mandated rate rollbacks, extraordinary assessments, and mandatory market lock-in arrangements in catastrophe-prone areas can adversely affect a company. Event risk may include changes in management, ownership, parental commitment, distribution, a legal ruling or regulatory development. Finally, event risk can also be influenced by potential regulatory or legislative reforms, economic conditions, interest rate levels, and financial market performance, as well as societal changes. For international companies, and domestic insurers operating abroad, political climates and sovereignty risks may also have a significant bearing on event risk.

SECTION X

AFFILIATION CODES AND RATING MODIFIERS

Affiliation Codes and Rating Modifiers are added to Best's Financial Strength Ratings to identify companies whose assigned rating is based on a Group (g), Pooled (p), or Reinsured (r) affiliation with other insurers. In addition, a company's rating may be placed Under Review and be subject to a near-term change, as indicated by the "u" rating modifier. A Best's Financial Strength Rating may carry a "pd" rating modifier, indicating that the company did not subscribe to our interactive rating process. The "s" rating modifier is assigned to syndicates operating at Lloyd's that have subscribed to our interactive rating process. These affiliation codes or modifiers appear as a lowercase suffix to the rating (i.e., A g, A u, A pd, etc.).

Insurers with affiliation codes (g, p, r) indicate that their rating is based on the consolidated performance of the company and its affiliation with one or more insurers, which collectively operate, in Best's opinion, as one coordinated insurance group and meets our criteria for the same rating. Accordingly, the Financial Size Category (see section XII) of these member companies usually equals that of the group.

Affiliation Codes

"g" Group Rating: Assigned to the parent company of a group and is based on the consolidation of the parent company and its insurance subsidiaries where ownership or board control exceeds 50%.

The group rating is also assigned to subsidiaries deemed to be integral to the group, which generally operate under common management and/or ownership. Group rated subsidiaries typically demonstrate a combination of the following characteristics. They are critical to the group's strategy and ongoing success; fully integrated into the group's strategic plan; carry the group name or are easily identified with the group; are material to the business profile of the group; are significant contributors to the group's earnings; currently benefit from some form of explicit parental support and have a history of receiving explicit support when needed. In certain cases, group ratings are also assigned to sister companies owned by a common holding company.

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

"p" Pooled Rating: Assigned to a group whose member companies pool assets, liabilities and operating results and maintain, in theory, the same operating performance and balance sheet strength as other companies within the pool. Pooling is viewed as explicit financial support. The assets of each pool participant are available for the protection of all pool members' policyholders. In many cases, pooled affiliates market under a common brand name and generally operate under common management and/or ownership.

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

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

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

Rating Modifiers

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

A company's rating remains under review until A.M. Best is able to fully determine the rating implications of the event before affirming, upgrading or downgrading the rating. Generally, a company's rating is placed under review for less than six months.

"pd" Public Data Rating: Assigned to Canadian property/casualty insurers and HMOs and health insurers (United States) that do not subscribe to our interactive rating process. Best's Public Data Ratings reflect both qualitative and quantitative analyses using publicly available data and other public information. Public Data Ratings will be assigned where, in Best's view, ratings are needed due to market demand.

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

RATING MODIFIER/AFFILIATION CODE DISTRIBUTION

Of the 2,286 individual total ratings assigned in Best's 2009 property/casualty publications, 1,572 or 69% were also assigned a Rating Modifier or Affiliation Code. Their distribution follows.

RATING MODIFIER/ AFFILIATION CODE	NUMBER OF COMPANIES
g - Group	713
p - Pooled	435
r - Reinsured	347
pd - Public Data	53
u - Under Review	47
Subtotal	**1,595**
Dual Assignment	(23)
Total Modifier/ Affiliation Code Ratings	**1,572**

SECTION XI

"NOT RATED" (NR) CATEGORIES

The current universe of rated property/casualty companies account for roughly 95% of the premium volume in the United States. However, A.M. Best also reports on 1,017 property/casualty companies that are not assigned a rating opinion. Because of their small size, Not Rated (NR) insurers constitute only 5% of the industry's premium writings.

For Not Rated (NR) companies, a condition exists that makes it difficult for A.M. Best to develop an opinion on the company's balance sheet strength and operating performance. Generally, these companies do not qualify for a Best's Credit Rating because of their limited financial information, small level of surplus, lack of sufficient operating experience, or due to their dormant or run-off status.

Companies are assigned to one of five Not Rated (NR) categories.

NR-1 (Insufficient Data)
Assigned predominately to small companies for which A.M. Best does not have sufficient financial information required to assign rating opinions. The information contained in these limited reports is obtained from several sources, which include the individual companies, the National Association of Insurance Commissioners (NAIC) and other data providers. Data received from the NAIC, in some cases, is prior to the completion of the cross-checking and validation process.

NR-2 (Insufficient Size and/or Operating Experience)
Assigned to companies that do not meet A.M. Best's minimum size and/or operating experience requirements. To be eligible for a letter rating, a company must generally have a minimum of $2 million in policyholders' surplus to assure reasonable financial stability and have sufficient operating experience to adequately evaluate its financial performance, usually two to five years. General exceptions to these requirements include companies that have financial or strategic affiliations with Best-rated companies; companies that have demonstrated long histories of financial performance; companies that have achieved significant market positions; and newly formed companies with experienced management that have acquired seasoned books of business and/or developed credible business plans.

NR-3 (Rating Procedure Inapplicable)
Assigned to companies that are not rated by A.M. Best, because our normal rating procedures do not apply due to a company's unique or unusual business features. This category includes companies that are in run-off with no active business writings, are effectively dormant, or underwrite financial or mortgage guaranty insurance. Exceptions to the assignment of the NR-3 designation include run-off companies that commenced run-off plans in the current year or inactive

companies that have been structurally separated from active affiliates within group structures that pose potential credit, legal or market risks to the group's active companies.

NR-4 (Company Request)
Assigned to companies that are assigned a Best's Credit Rating following a review of their financial performance, but request that the assigned letter rating not be published on their company. The NR-4 is assigned following the publication of a final letter-rating opinion.

NR-5 (Not Formally Followed)
Assigned to insurers that are not formally evaluated for the purposes of assigning a rating opinion. It is also assigned retroactively to the rating history of traditional U.S. insurers when they provide prior year(s) financial information to A.M. Best and receive a Best's Credit Rating or another NR designation in more recent years. Finally, it is assigned currently to those companies that historically had been rated, but no longer provide financial information to A.M. Best because they have been liquidated, dissolved, or merged out of existence.

SECTION XII

FINANCIAL SIZE CATEGORIES (FSC)

A.M. Best assigns a Financial Size Category (FSC) to each letter-rated company. The FSC is designed to provide the subscriber with a convenient indicator of the size of a company in terms of its most recent cross-checked submission of year-end, first-, second- or third-quarter regulatory surplus and related accounts. Many insurance buyers consider buying insurance coverage from companies that they believe have the sufficient financial capacity to provide the necessary policy limits to insure their risks.

Best's Financial Size Category is based on reported policyholders' surplus plus conditional or technical reserve funds, such as the asset valuation reserve (AVR), other investment and operating contingency funds and miscellaneous voluntary reserves reported as liabilities in U.S. dollars.

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

2009 FINANCIAL SIZE CATEGORY (FSC)
BY INDIVIDUAL COMPANIES

Financial Size Category	Adjusted Policyholders' Surplus ($ Millions)	Number of Companies	Distribution Percentage	Distribution Cumulative
Class I	Less than 1	2	0.1 %	0.1 %
Class II	1 to 2	16	0.7	0.8
Class III	2 to 5	50	2.2	3.0
Class IV	5 to 10	115	5.1	8.1
Class V	10 to 25	188	8.3	16.4
Class VI	25 to 50	155	6.8	23.2
Class VII	50 to 100	194	8.5	31.7
Class VIII	100 to 250	352	15.5	47.2
Class IX	250 to 500	212	9.3	56.5
Class X	500 to 750	171	7.5	64.0
Class XI	750 to 1,000	73	3.2	67.2
Class XII	1,000 to 1,250	79	3.5	70.7
Class XIII	1,250 to 1,500	86	3.8	74.5
Class XIV	1,500 to 2,000	71	3.1	77.6
Class XV	2,000 or greater	507	22.4	100.0 %
	Subtotal	2,271		
	E & F Rated Companies	15		
	Grand Total	2,286		

2009 FINANCIAL SIZE CATEGORY (FSC)
BY RATING UNITS

Financial Size Category	Adjusted Policyholders' Surplus ($ Millions)	Number of Rating Units	Distribution Percentage	Distribution Cumulative
Class I	Less than 1	2	0.2 %	0.2 %
Class II	1 to 2	16	1.5	1.7
Class III	2 to 5	50	4.7	6.4
Class IV	5 to 10	113	10.6	17.0
Class V	10 to 25	178	16.7	33.7
Class VI	25 to 50	135	12.7	46.4
Class VII	50 to 100	147	13.8	60.2
Class VIII	100 to 250	175	16.5	76.7
Class IX	250 to 500	82	7.7	84.4
Class X	500 to 750	43	4.0	88.4
Class XI	750 to 1,000	23	2.2	90.6
Class XII	1,000 to 1,250	16	1.5	92.1
Class XIII	1,250 to 1,500	19	1.8	93.9
Class XIV	1,500 to 2,000	13	1.2	95.1
Class XV	2,000 or greater	52	4.9	100.0 %
	Subtotal	1,064		
	E & F Rating Units	15		
	Grand Total	1,079		

SECTION XIII

RATING DISTRIBUTIONS

The following section provides the distribution of Best's Financial Strength Ratings on both an individual company and rating unit basis as of July 20, 2009. In addition, this section provides the distribution of companies assigned to Not Rated (NR) categories.

The term "rating unit" applies to either individual insurers or a consolidation of member companies. The rating unit forms the financial basis on which A.M. Best performs its rating evaluation. The name of a company's rating unit is identified in its full report and can also be found in the Company Groups section of our publications. The financial results of rating units more accurately represent the way insurance groups operate and manage their businesses. Therefore, the rating distribution based on a rating unit basis is the more appropriate rating distribution to gauge A.M. Best's overall opinion of the financial health of the universe of insurance companies we rate.

2009 PROPERTY/CASUALTY RATING DISTRIBUTION* BY INDIVIDUAL COMPANIES

FSR	Rating Category	Number	Percent
	Secure Ratings		
A++	Superior	73	3.2%
A+	Superior	386	16.9
	Subtotal	**459**	**20.1**
A	Excellent	778	34.0
A-	Excellent	610	26.7
	Subtotal	**1,388**	**60.7**
B++	Good	205	9.0
B+	Good	120	5.2
	Subtotal	**325**	**14.2**
	Total Secure Ratings	**2,172**	**95.0%**
	Vulnerable Ratings		
B	Fair	58	2.5%
B-	Fair	23	1.0
	Subtotal	**81**	**3.5**
C++	Marginal	10	0.4
C+	Marginal	3	0.2
	Subtotal	**13**	**0.6**
C	Weak	3	0.2
C-	Weak	1	0.0
	Subtotal	**4**	**0.2**
D	Poor	1	0.0
E	Under Regulatory Supervision	12	0.5
F	In Liquidation	3	0.2
	Subtotal	**16**	**0.7**
	Total Vulnerable Ratings	**114**	**5.0%**
	Total Rating Opinions	**2,286**	**100.0%**
	No Rating Opinions		
NR-1	Insufficient Data	531	52.2%
NR-2	Insufficient Size/ Operating Experience	29	2.9
NR-3	Rating Procedure Inapplicable	147	14.4
NR-4	Company Request	25	2.5
NR-5	Not Formally Followed	285	28.0
	Total No Rating Opinions	**1,017**	**100.0%**
	Total Reported Companies	**3,303**	

*As of July 20, 2009

2009 PROPERTY/CASUALTY RATING DISTRIBUTION* BY RATING UNITS

FSR	Rating Category	Number	Percent
	Secure Ratings		
A++	Superior	17	1.6%
A+	Superior	84	7.8
	Subtotal	**101**	**9.4**
A	Excellent	266	24.6
A-	Excellent	356	33.0
	Subtotal	**622**	**57.6**
B++	Good	151	14.0
B+	Good	104	9.6
	Subtotal	**255**	**23.6**
	Total Secure Ratings	**978**	**90.6%**
	Vulnerable Ratings		
B	Fair	51	4.7%
B-	Fair	17	1.6
	Subtotal	**68**	**6.3**
C++	Marginal	10	0.9
C+	Marginal	3	0.3
	Subtotal	**13**	**1.2**
C	Weak	3	0.3
C-	Weak	1	0.1
	Subtotal	**4**	**0.4**
D	Poor	1	0.1
E	Under Regulatory Supervision	12	1.1
F	In Liquidation	3	0.3
	Subtotal	**16**	**1.5**
	Total Vulnerable Ratings	**101**	**9.4%**
	Total Rating Opinions	**1,079**	**100.0%**
	No Rating Opinions		
NR-1	Insufficient Data	531	50.9%
NR-2	Insufficient Size/ Operating Experience	29	2.8
NR-3	Rating Procedure Inapplicable	147	14.1
NR-4	Company Request	25	2.4
NR-5	Not Formally Followed	311	29.8
	Total No Rating Opinions	**1,043**	**100.0%**
	Total Reported Units	**2,122**	

*As of July 20, 2009

SECTION XIV

DEFINITIONS

ORGANIZATION TYPES

Insurance transactions are conducted primarily through five types of organizations—stock companies, mutual companies, U.S. Lloyds organizations, Reciprocal Exchanges and Risk Retention Groups. A brief description of the legal structure and function of each is as follows:

• **Stock Companies:** Stock companies are corporations, the financial ownership of which is comprised of capital stock which is divided into shares. Ultimate control of stock insurance companies is vested in the shareholders.

• **Mutual Companies:** Mutual companies are corporations without capital stock. Ultimate control of mutual insurance companies is vested in their policyholders.

• **U.S. Lloyds Organizations:** These organizations are voluntary unincorporated associations of individuals. Each individual assumes a specified portion of the liability under each policy issued. The organizations operate through a common attorney-in-fact appointed for this purpose by the underwriters.

• **Reciprocal Exchanges:** These organizations are composed of a group of persons, firms or corporations commonly termed "Subscribers" who exchange contracts of insurance on a Reciprocal or Inter-Insurance plan through the medium of an attorney-in-fact. Under this plan, each Subscriber executes an agreement identical with that executed by every other Subscriber, empowering the attorney-in-fact to assume on his behalf an underwriting liability on policies issued by the Exchange covering the risks of the other Subscribers. Customarily, the attorney-in-fact is compensated by payment of a percentage of premium income, out of which most operating expenses are paid.

• **Risk Retention Groups (RRG):** These entities, formed under the federal Liability Risk Retention Act of 1986 of the United States, enable businesses or professionals with similar risks to band together to provide needed liability coverages for each other. Under statute, RRGs are precluded from writing certain coverages, most notably property lines and workers' compensation. RRGs predominantly write medical malpractice, general liability, professional liability, product liability and excess liability coverages. An RRG can be formed as a mutual or stock company or a reciprocal.

INSURANCE LICENSES

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

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

In addition to licensed insurers, there are several other specialty types of companies, that exist in the field of insurance such as reinsurers, non-admitted surplus lines carriers and risk retention groups.

A reinsurer is a company that agrees to indemnify, for consideration, the ceding company against all or part of a loss that the latter may sustain under policies that it has issued. Reinsurers do not always have to be licensed and may operate on an approved basis in some states. A surplus lines insurer is a company that underwrites risks for which insurance coverage generally is not available through a company licensed in the insured's state (an admitted insurer). This business, therefore, is placed with a non-admitted insurer (a company not licensed in the state) in accordance with excess or surplus lines provisions of state insurance laws. A risk retention group is an insurer that generally is not licensed in a state but operates under the authority of the federal Liability Risk Retention Act of 1986.

Since there are a number of different licensing requirements, we have used seven descriptions to signify the general status of a company in a particular jurisdiction.

• **State of Domicile:** The state in which the company is incorporated or chartered. The company is also licensed (admitted) under the state's insurance statutes for those lines of business for which it qualifies.

• **Licensed:** Indicates the company is incorporated (or chartered) in another state but is a licensed (admitted or chartered) insurer for this state to write specific lines of business for which it qualifies.

• **Licensed for Reinsurance Only:** Indicates the company is licensed (admitted) to write reinsurance on risks in this state. Indicates the company is incorporated (or chartered) in another state but is a licensed (admitted) reinsurer for this state.

• **Approved for Reinsurance:** Indicates the company is approved (or authorized) to write reinsurance on risks in this state. A license to write reinsurance may not be required in these states. Indicates that the company is accredited or credit is allowed for reinsurers domiciled and licensed in another state. These reinsurers meet size and regulatory filing requirements that were included as part of the NAIC Model Law on Credit for Reinsurance.

• **Credit for Reinsurance (Other):** Indicates that the company meets state requirements other than licensing or accreditation. Included are reinsurers that maintain trust funds, reinsurance arrangements that are required by law (pools, joint underwriting associations, state-owned or controlled companies) and qualified trust agreements and letters of credit arrangements. These requirements were also specified under the Model Law.

• **Approved or not Disapproved for Surplus Lines:** Indicates the company is approved (or not disapproved) to write excess or surplus lines in this state.

• **Authorized under federal Liability Risk Retention Acts (Risk Retention Groups):** Indicates companies operating under the federal Products Liability Risk Retention Act of 1981 and the Liability Risk Retention Act of 1986. Indicates states in which the company operates for members whose business or activities are similar or related with respect to the liability to which members are exposed by virtue of any related, similar, or common business, trade, product, services, premises, or operations. Companies are licensed in the state of domicile only.

BALANCE SHEET TERMS

• **Unaffiliated Investments:** Cash, bonds, stocks, mortgages, real estate and accrued interest, excluding investments in affiliates and real estate properties occupied by the company.

• **Investments in Affiliates:** Bonds, stocks, collateral loans, short-term investments in affiliates, and real estate properties occupied by the company.

• **Premium Balances:** Premiums and agents' balances in course of collection; premiums, agents' balances and installments booked but deferred and not yet due; bills receivable, taken for premiums and accrued retrospective premiums.

• **Total Admitted Assets:** This item is the sum of all admitted assets. These assets are valued in accordance with state laws and regulations, as reported by the company in its financial statements filed with state insurance regulatory authorities.

• **Losses and Loss Adjustment Expenses:** This item represents the total reserves for unpaid losses and loss adjustment expenses, including reserves for incurred but not reported losses (IBNR), if any, and supplemental reserves established by the company.

• **Unearned Premiums:** The calculated aggregate net amount, after deducting reinsurance credits, which an insurance company would be obliged to tender to its policyholders as return premiums for the unexpired terms, should it cancel every policy in force.

• **Conditional Reserves**: This item represents the aggregate of various reserves which, for technical reasons, are treated by companies as liabilities. Such reserves, which are similar to free resources or surplus, include unauthorized reinsurance, dividends to policyholders undeclared and other similar reserves established voluntarily or in compliance with statutory regulations.

• **Policyholders' Surplus:** This item is the sum of paid-in capital, paid-in and contributed surplus, and net earned surplus, including voluntary contingency reserves.

INCOME STATEMENT TERMS

• **Direct Premiums Written:** This item represents the aggregate amount of recorded originated premiums, other than reinsurance, written during the year whether collected or not at the close of the year (plus retrospective audit premium collections), after deducting all return premiums.

• **Reinsurance Assumed:** Premiums assumed from other affiliated and non-affiliated insurance companies for reinsurance.

• **Reinsurance Ceded:** Premiums ceded to other affiliated and non-affiliated insurance companies.

• **Net Premiums Written:** This item represents gross premiums written, direct and reinsurance assumed, less reinsurance ceded.

• **Net Premiums Earned:** This item represents the adjustment of the net premiums written for the increase or decrease during the year of the liability of the company for unearned premiums.

• **Business Net Retention:** The percentage of a company's gross writings that are retained for its own account. Gross writings are the sum of direct writings and assumed writings.

• **Losses Incurred (Pure Losses):** Net paid losses during the current year plus (minus) the change in loss reserves since the prior year-end.

• **Loss Adjustment Expenses:** Expenses incurred to investigate and settle losses.

• **Underwriting Expenses Incurred:** Expenses, including net commissions, salaries and advertising costs, which are attributable to the production of net premiums written.

• **Net Underwriting Income:** Net premiums earned less incurred losses, loss adjustment expenses, underwriting expenses incurred, and dividends to policyholders.

• **Other Income/Expenses:** Miscellaneous sources of operating income or expense that principally relate to premium finance income or charges for uncollectible premium and reinsurance balances.

• **Net Investment Income:** Investment income earned during the year less investment expenses and depreciation on real estate.

• **Pretax Operating Income:** Pretax operating earnings, before any capital gains, generated from underwriting, investment and other miscellaneous operating sources.

• **Income Taxes:** Incurred income taxes (including income taxes on capital gains) reported in each annual statement for that year.

• **Net Income:** Total after-tax earnings generated from operations and realized capital gains.

• **Change in Policyholders' Surplus:** The annual change in a company's policyholders' surplus derived from operating earnings, investment gains, net contributed capital and other miscellaneous sources.