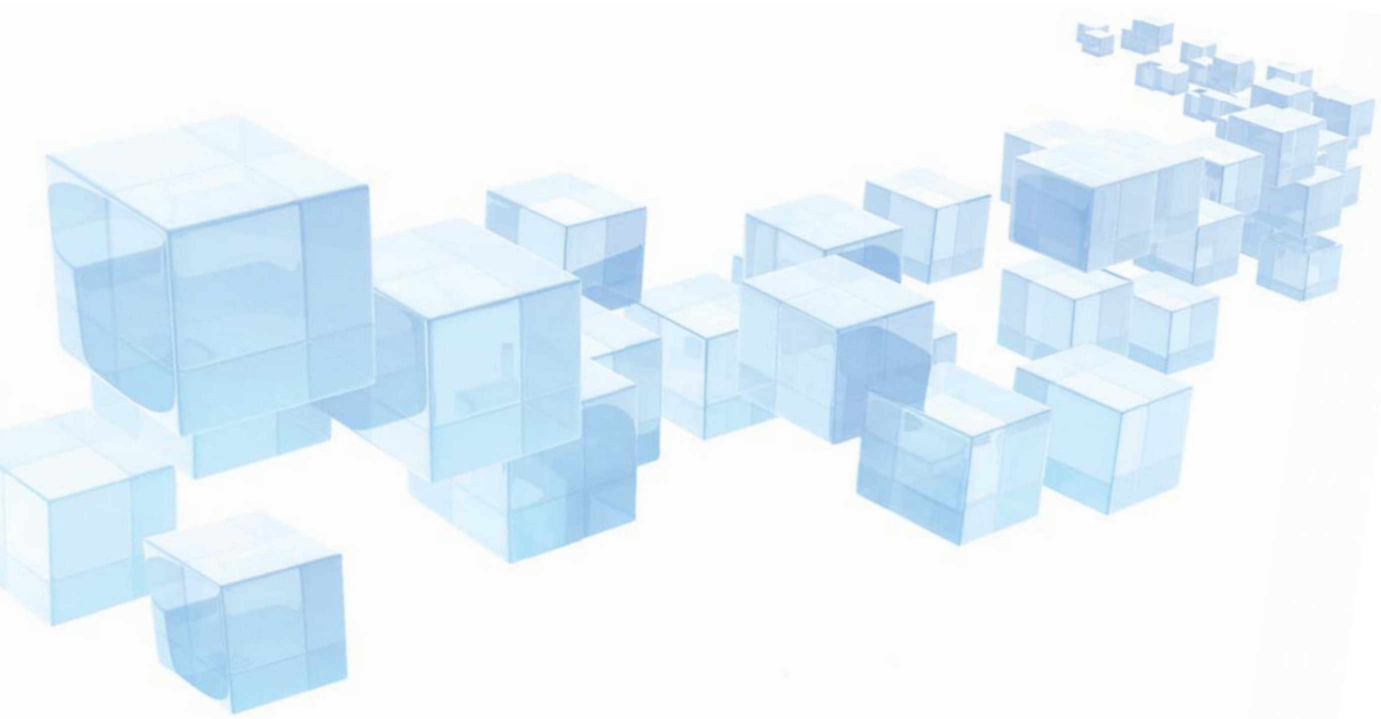
BEST'S METHODOLOGY AND CRITERIA

Rating Surety Companies

October 13, 2017



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Rating Surety Companies

Outline

A. Market Overview
B. Balance Sheet Strength
C. Operating Performance
D. Business Profile
E. Enterprise Risk Management (ERM)

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of A.M. Best Rating Services' rating process.

A. Market Overview

Surety insurance involves a three-party contract, rather than a traditional insurance agreement between an insurer and an insured. A surety bond is a three-party agreement among the surety company, a principal, and the obligee. The surety guarantees the performance and payment obligations of the principal to the obligee as contracted, which can include the suppliers and subcontractors of the principal. The principal pays the surety a premium for this guarantee. If the principal does not have adequate financial resources to qualify for a bond, the surety may accept collateral. There are multiple types of surety contracts and their specific characteristics are taken into account in the rating process, as discussed in this criteria procedure.

Types of Surety

Commercial Surety Bonds

Commercial surety bonds include license and permit bonds (including motor vehicle dealer bonds and contractor license bonds); brokers' bonds (including insurance, mortgage, and title agency bonds); public official bonds; and miscellaneous bonds that often support private relationships and unusual business needs (e.g., income tax bonds, customs bonds, and workers' compensation self-insurance bonds). This type of bond covers many kinds of obligations, including reclamation/abandonment, financial guarantee, and compliance. Some bonds allow cancellations, while others limit the ability to cancel a bond.

Contract Surety Bonds

Contract surety bonds include bid and performance bonds (the latter can include maintenance and subdivision bonds) and payment bonds. For U.S. companies, insurers that have complied with the laws and regulations outlined in 31 U.S. Code Chapter 93 are listed as acceptable sureties on federal bonds. Under contract surety, a principal is evaluated based on its capacity, capital, and character—the Three Cs.

Some contract surety writers, in addition to using collateral, use funds control, whereby the surety controls the disbursement and administration of funds for the principal on a construction project, for example. Funds control ensures that there is no commingling of funds between projects and helps a contractor to better meet its obligations to suppliers, subcontractors, and obligees.

Court Bonds

Court bonds are prescribed by statute and can be further broken down into two broad categories. Fiduciary bonds are required by the court, to ensure that individuals in a position of trust will safeguard assets belonging to others placed under their control. Judicial bonds are required in judicial proceedings and include appeal bonds, guardianship bonds, and bail bonds.

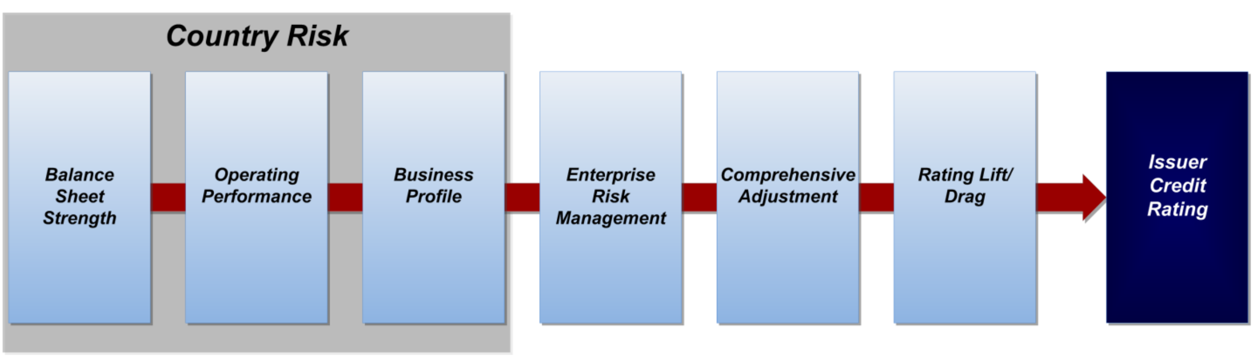
A bail bond is a type of judicial bond that guarantees the appearance of a criminal defendant in court. Bail bonds are unique in that bail agents are contractually obligated to make sure a criminal defendant appears in court at the proper time. In the U.S., the gross premium a defendant pays for a bail bond is generally 10% of the bond limit. The bail agent is the insurer's first line of defense against potential loss, so the agent typically receives a commission of approximately 90% of the gross premium so that it has the financial resources to assure compliance with the court. Because the insurer keeps approximately 10% of the premium charged by the agent, and the premium charged by the agent is 10% of the bond limit, the net premium retained by the insurer is approximately 1% of the bond limit.

Depending on the location, some bail insurers are required to report their premiums net of commissions; others are required to report their premiums gross of commissions. This has implications for how A.M. Best treats premiums in its Best's Capital Adequacy Ratio (BCAR) model, a component of the balance sheet strength assessment.

A.M. Best's Rating Process

A.M. Best reviews key rating factors or building blocks—namely balance sheet strength, operating performance, business profile, and enterprise risk management (ERM)—when rating an insurer (**Exhibit A.1**). This criteria procedure focuses on considerations that are specific to surety insurers within the various building blocks.

Exhibit A.1: A.M. Best's Rating Process



B. Balance Sheet Strength

Balance sheet strength is the foundation of A.M. Best's credit ratings. Owing to their particular characteristics, surety writers have specific BCAR, stress test, and liquidity considerations—in addition to the balance sheet strength factors in the BCRM—that must be considered in the balance sheet strength assessment.

BCAR

In calculating the BCAR of contract surety writers, bail bond insurers, and some commercial surety companies, A.M. Best includes an adjustment to net required capital to account for a potential large loss. These potential large losses are developed based on information provided by the surety company pertaining to its largest exposures, which may include open limits, limits that expired in the past 12 months, the cost to complete, historical large losses incurred, reinsurance programs, co-sureties, etc.

Commercial Surety Writers

Non-construction commercial surety portfolios that contain several large potential loss exposures are evaluated similarly to construction contract exposures by estimating a potential large net loss for each large exposure and using the largest potential losses in the BCAR analysis. However, if the exposures are smaller and more effectively analyzed in the aggregate, A.M. Best analyzes the aggregate exposure similarly to other property/casualty lines of business whose non-catastrophe premium and reserve risks are captured by the capital factors in the BCAR.

Contract Surety Writers

For contract surety writers, the potential large loss is the largest net pre-tax loss, selected from the principals with the largest exposures, such that the net loss for each principal is based on the 90% probable maximum loss (PML), net of collateral and reinsurance. The 90% PML for each principal can be calculated using the most current construction loss severity model developed by the Surety & Fidelity Association of America (SFAA). The principals examined are based on the total bond limits for each principal, for which the total bond limits equal the sum of in-force bond limits plus the sum of all bond limits expired in the past 12 months. This PML is used across all of the VaR levels in the BCAR model. **Exhibit B.1** shows sample calculations of the net pre-tax loss.

Exhibit B.1: Sample Calculation of Potential Losses for Contract Surety*

	Largest Exposure	2nd Largest Exposure	3rd largest Exposure	4th Largest Exposure	5th Largest Exposure
1 Gross Exposure for Principal	10,000,000	7,000,000	5,000,000	3,000,000	2,000,000
2 SFAA Loss Severity Model 90% PML Factor	0.15	0.30	0.16	25	0.40
3 Loss Severity Model 90% PML Amount = (1) * (2)	1,500,000	2,100,000	800,000	750,000	800,000
4 Co-Surety's Share %	40	20	0	0	0
5 Co-Surety's Share Amount = (3) * (4)	600,000	420,000	0	0	0
6 Net PML Amount after Co-Surety = (3) - (5)	900,000	1,680,000	800,000	750,000	800,000
7 Acceptable[1] Collateral Amount	300,000	180,000	100,000	150,000	50,000
8 Net PML Amount after Co-Surety & Collateral = (6) - (7)	600,000	1,500,000	700,000	600,000	750,000
9 XOL Reinsurance Amount	0	500,000	0	0	0
10 Quota Share Reinsurance Amount	120,000	200,000	140,000	120,000	150,000
11 Pre-Tax Net Potential Loss Amount = (8) - (9) - (10)	**480,000**	**800,000[2]**	**560,000**	**480,000**	**600,000[3]**

[1]Collateral must be easily and quickly convertible into cash.
[2]Largest Pre Tax Net Loss
[3]Second Largest Pre Tax net Loss

* Loss Severity Model Factors are based on the type of business, region of operation, size of total limits, and concentration of bond limits for that principal. Amounts are in U.S. dollars.

Bail Bond Insurers

To ensure consistent treatment of bail bond insurers, A.M. Best uses the bail bond premium written net of commission as the basis for determining required capital for pricing risk on the premium risk page in the BCAR. For U.S. insurers, this information can be obtained from the Bail Bond Supplement in the statutory statement. The capital factors applied to the net premium vary according to the size of net premium and the profitability of the bail bond business. **Exhibit B.2** shows the sample calculation for a profitable company, and **Exhibit B.3**, for an unprofitable company. The benefit of using the net premium is that it shows the difference in the relative net exposure of insurers that have a managing general agency (MGA) structure versus those that do not. Bail bond insurers with an MGA structure retain a lower net premium because of the extra layer of commissions paid, but some of the losses are absorbed at the MGA level, resulting in lower net exposure to the bail bond insurer. Premiums net of commission can be reduced for premium ceded to reinsurers after capital factors have been determined using premium net of commission only.

Exhibit B.2: Sample Factors for a Highly Profitable Company

	Industry Baseline Bail Bond Written Premium Capital Factors					Company's Adjusted Bail Bond Written Premium Capital Factors			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
						= (1) * (5)	= (2) * (5)	= (3) * (5)	= (4) * (5)
Written Premium NET of Commission	VaR 95	VaR 99	VaR 99.5	VaR 99.6	UW Profitability Factor*	VaR 95	VaR 99	VaR 99.5	VaR 99.6
NWP < $2 million	0.324	0.503	0.575	0.597	0.80	0.259	0.402	0.460	0.478
$2m <= NWP < $5m	0.268	0.409	0.466	0.483	0.80	0.214	0.327	0.373	0.386
$5m <= NWP < $10m	0.214	0.323	0.366	0.379	0.80	0.171	0.258	0.293	0.303
NWP >= $10m	0.180	0.268	0.303	0.313	0.80	0.144	0.214	0.242	0.250

* Profitability Factor varies from 0.80 (highest profitability levels) to 1.20 (unprofitable).

Exhibit B.3: Sample Factors for an Unprofitable Company

	Industry Baseline Bail Bond Written Premium Capital Factors					Company's Adjusted Bail Bond Written Premium Capital Factors			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
						= (1) * (5)	= (2) * (5)	= (3) * (5)	= (4) * (5)
Written Premium NET of Commission	VaR 95	VaR 99	VaR 99.5	VaR 99.6	UW Profitability Factor*	VaR 95	VaR 99	VaR 99.5	VaR 99.6
NWP < $2 million	0.324	0.503	0.575	0.597	1.20	0.389	0.604	0.690	0.716
$2m <= NWP < $5m	0.268	0.409	0.466	0.483	1.20	0.322	0.491	0.559	0.580
$5m <= NWP < $10m	0.214	0.323	0.366	0.379	1.20	0.257	0.388	0.439	0.455
NWP >= $10m	0.180	0.268	0.303	0.313	1.20	0.216	0.322	0.364	0.376

* Profitability Factor varies from 0.80 (highest profitability levels) to 1.20 (unprofitable).

A.M. Best gathers information on the five largest bail agents producing business for the insurer. The open liability amount is used to determine the five largest producing agents. For each of the top five agents, A.M. Best lowers the open liability to approximate the true current open liability, given that the reported open liability is typically overstated owing to lags in the reporting of bond closures. A bond forfeiture rate of 3% is applied to the adjusted open liability for each bail agent, and the build-up fund (BUF) held for that agent is used to lower the agent's loss exposure. The largest net pre-tax amount from those five agents is used as a potential loss in the published BCAR. **Exhibit B.4** shows a sample calculation of the net pre-tax loss. A.M. Best also reviews the insurer's current and historical total forfeitures to determine whether the amounts calculated for the top five agents need to be adjusted.

Exhibit B.4: Sample Calculation of Potential Losses for Bail ($ Thousands)

Top Bail Agents	Reported Open Liability	Adjustment %	Estimated Current Open Liability	3% Bond Forfeiture Rate	BUF Balance	Gross Exposure	Reinsurance Amount	Pre-Tax Net Exposure
Agent 1	1,000,000	50%	500,000	15,000	10,000	5,000	2,000	3,000*
Agent 2	500,000	50%	250,000	7,500	2,000	5,500	2,200	3,300**
Agent 3	300,000	50%	150,000	4,500	1,000	3,500	1,400	2,100
Agent 4	200,000	50%	100,000	3,000	500	2,500	1,000	1,500
Agent 5	100,000	50%	50,000	1,500	200	1,300	520	780

* Second Largest Net loss
** Largest Net Loss

Premium Taxes

Bail insurers face potential liabilities for premium tax payments. Where insurers are required to report premiums gross of commission, some have reported premiums on a net basis, resulting in an accumulated liability for insufficient premium tax payments. A reduction to surplus in the insurer's BCAR for this potential liability may be necessary if the insurer has not accrued an estimated liability on its own.

BCAR Stress Test

A.M. Best may conduct a stress test on the surety insurer's BCAR. A stressed BCAR can be calculated by assuming the largest net loss has occurred and then estimating what the insurer's BCAR would look like shortly after that first event occurred. This assumption results in a reduction to reported surplus in the amount of the largest net loss, followed by an increase in recoverables (40% of the ceded loss), an increase in the net loss reserves (40% of the net pretax loss), and a reduction to surplus for the second-largest potential net loss calculated from the principals with the largest exposures. The 40% factor may be adjusted up or down by the analyst based on the reinsurance contracts in place. Although these stress-tested BCAR results are not published, they do affect A.M. Best's view of capitalization.

The analyst may decide that additional testing and/or adjustments to the stress test are appropriate. If an insurer writes both contract surety and bail, the potential losses used in BCAR are derived from the calculations generating the higher potential losses. For those insurers that write other lines of business exposed to other, uncorrelated catastrophe losses, the potential large losses used in BCAR are the higher of surety, bail, catastrophe, or other potential or actual recent large losses.

Liquidity Ratios

Bail Bond Insurers

Bail agents set aside a portion of their commission income in build-up funds to which the insurer has access if an agent is unable to meet its obligations. For some insurers, the aggregate amount in the BUF accounts can be sizable; it also can distort the balance sheet, given that many bail companies record the BUF accounts as both a non-invested asset and a liability. As a result, current liquidity ratios (roughly defined as cash and invested assets divided by liabilities) may be low for bail bond writers because of the BUF liability. Because this liability is supported by non-invested assets, removing the impact from this ratio is important, as doing so provides a better view of the insurer's balance sheet liquidity. Note: BUF accounts are not commingled, and as a result, an insurer cannot reduce losses from one agency by using the BUF accumulated by another agency.

C. Operating Performance

When rating a surety insurer, it is important to note that surety insurers' operating metrics can be quite different from those of traditional property/casualty insurers. Typically, surety insurers incur lower losses than the general property/casualty population owing to their focus on the Three Cs. This, combined with the agent structure of some surety writers, can result in loss, expense, and combined ratios that do not reflect the experience of the general property/casualty population.

Bail Bond Insurers

Bail bond insurers typically incur very low losses, as they are absorbed by the agents (through the BUF). However, with 90% or more of premiums retained by agents as commissions, this leaves a very low premium base with the insurer; expense ratios therefore tend to be very high, typically exceeding 80%. When a bail writer has an affiliated general agent that is responsible for bail production, A.M. Best may also look at that agency's expense structure and operating results, to determine whether any of the agency's potential losses could spill over to the insurer in the form of a demand for capital (owing to common ownership).

D. Business Profile

Certain elements of a surety writer's portfolio management may be highlighted during the business profile evaluation. In particular, surety-specific considerations can have an impact on the assessments of product/geographic concentration and product risk components.

Product/Geographic Concentration

When evaluating a surety writer's business profile, the size and distribution of the surety's bonds and accounts are key areas of review. The analyst may consider the surety writer's exposure concentration by size of accounts and by the number of bonds in an individual account. Trends and changes in distribution of accounts by size or bonds written may be reviewed.

Product Risk

The evaluation of a surety writer's product risk focuses on both the type of surety written and the presence of tenor/tail risk in its product offerings. The existence of any potentially hazardous exposures, such as a financial guarantee or a more risky commercial surety, could result in a negative assessment for this component; however, the distribution of the surety writer's portfolio would determine the weighting associated with this negative. To evaluate whether the surety writer's products are subject to tenor/tail risk, the analyst may examine the distribution of the surety's bonds by duration, any atypical long-term exposures covered by the surety, and the surety writer's ability to cancel bonds.

E. Enterprise Risk Management (ERM)

Surety's three-party contract setup raises certain ERM concerns, specifically in relation to a surety writer's product and underwriting, as well as its reinsurance risk evaluations. Sureties with limited analytical capabilities would be viewed more negatively in the assessment of this component.

Product & Underwriting

The success of a surety operation is linked to its principals, and the monitoring of the credit quality of its principals, including the frequency of monitoring, is a key element of the evaluation. If surety insurers accept lower-credit quality risks, or if the credit quality of the principal declines, the analyst may focus on how the surety mitigates the increase in this type of risk.

Joint ventures can also heighten a surety insurer's risk. The surety writer's liability, should one of the contractors fail to meet its obligations in the joint venture, may affect the assessment of this component.

Reinsurance

Outside of traditional reinsurance, surety writers have access to alternative risk mitigation strategies, such as requiring collateral from the principal and contracting with co-sureties to issue bonds (with co-surety two or more sureties provide the bond). The assessment may take into account the type of collateral guaranteeing the bond and its liquidity, along with the processes and procedures associated with accepting collateral, estimating its value, replenishing it should its value decline, and controlling and releasing it. Whether the contract stipulates funds control and whether the funds control is done in-house or facilitated by a third party may also factor into the assessment. If an insurer uses a co-surety, the procedure for using and selecting another insurer as a co-surety, the expertise, credit quality, and capacity of the co-surety, and the surety insurer's liability in the event of the co-surety's default may be discussed with the company during the rating process.

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