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## Rating Surety Companies

Although surety insurance companies are analyzed with other property/casualty (P/C) insurers, their unique characteristics require additional analysis during the rating evaluation. This criteria procedure highlights some of the major categories of surety insurance written by insurers rated by A.M. Best, and describes some of the additional analysis performed beyond that of a typical P/C writer.

One of the distinguishing characteristics of surety insurance is that it 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 includes the suppliers and subcontractors of the principal. The principal pays a premium to the surety for this guarantee.

**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 unique business needs (e.g., income tax bonds, customs bonds and workers' compensation self insurance bonds).

The obligations of commercial surety risks can be many different types, including: reclamation/abandonment, financial guarantee and compliance. Some commercial surety bonds have cancellation provisions, while others have a limited ability to cancel the bond.

**Contract surety bonds** include bid and performance bonds (the latter can include maintenance and subdivision bonds) and payment bonds. Since many construction projects involve federal funding, companies that have complied with the laws and regulations of the U.S. Department of the Treasury are listed as acceptable sureties on federal bonds under Title 31 U.S.C. 9304-9308 of the United States Code. This Treasury listing is commonly referred to as the "T-listing." This allows the surety to insure contractors involved with federal projects. A T-listing generally allows a surety to provide a contract limit of up to 10% of the surety's capital and surplus per bond issued. Higher limits can be offered, but the excess would have to be reinsured, co-insured or otherwise protected so that the net limit is within the 10% underwriting limitation.

Under contract surety, a surety evaluates a principal based on the "three C's": capacity, capital and character.

- Surety makes sure the principal has the capacity (i.e. the skills, systems and management abilities) to perform its obligations under the contract.
- Surety checks the principal's finances to be sure it has the financial strength (capital) to fulfill the contract.
- Surety researches the principal's character, experience and reputation through interviews and public records to gain an understanding of its ability to meet the contractual obligations to the obligee.

The A.M. Best analyst needs to understand how the surety insurer implements the three C's in the underwriting process, as well as gain a level of understanding of the insurer's systems, controls and risk management practices.

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In cases where a principal may not have adequate capital to qualify for a bond, the surety may accept collateral from the principal. Collateral, as utilized in surety, is an asset pledged to and held by the surety as a means of securing the performance of the principal. Some contract surety writers also utilize funds control. Under this practice, the surety controls the disbursement and administration of funds for the principal on a construction project. In this way, the surety can be certain there is no commingling of funds between projects and is also in a better position to assist the contractor in meeting its obligations to the suppliers, subcontractors and obligee.

A.M. Best reviews both quantitative and qualitative factors when assigning a rating to an insurer. When reviewing a contract surety insurer, the following qualitative factors will typically require additional focus in the rating process:

**(1) Portfolio Management:**

- a. Credit Quality:
  - i. How the surety determines the credit quality of its principals.
  - ii. Tools or models used in credit quality analysis.
  - iii. How often the credit quality of each principal is reviewed.
  - iv. Distribution of risks by credit quality and any changes.
  - v. Procedures when a principal has a drop in credit quality.
  - vi. For lower quality risks, how the increased risk is mitigated.
- b. Geographic spread of risk
  - i. The geographic spread or concentration of the portfolio of risks.
  - ii. Understanding of the legislative, regulatory, judicial, and economic risks in the locations where they currently operate or plan to operate.
  - iii. Reasons for any changes in geographic spread – well researched and planned growth vs. following growth of principals.
- c. Account size distribution:
  - i. Typical size of an account written by the surety.
  - ii. Diversification or concentration by size of account.
  - iii. Exposure concentrations in a small number of large accounts, or spread over many accounts.
  - iv. Changes in account size distribution.
- d. Bond size:
  - i. Typical size of bonds written by the surety.
  - ii. Concentration of bonds within an individual account.
  - iii. Changes in typical size of bonds written.
- e. Tenor/tail risk:
  - i. Duration of typical bonds written by the surety.
  - ii. Distribution of bonds by duration.
  - iii. Changes in duration.
  - iv. Existence of any nontypical, long-term exposures.
  - v. Insurer's ability to cancel bonds.
- f. Account composition or business risk:
  - i. Types of surety written.
  - ii. Existence of any potentially hazardous exposures, such as financial guarantee or more risky commercial surety.
  - iii. Distribution by type of surety.
  - iv. Changes in distribution by type of surety.

**(2) Claims:**

- a. Claims department operations conducted in house or through an outside vendor.
- b. Claims-handling philosophy, including case load per adjuster, settlement authority, attorney relationships, expertise, etc.

- c. Reserving practices:
  - i. Procedures for setting initial case reserve, changes to case reserve.
  - ii. Procedures for setting incurred but not reported (IBNR) reserves
  - iii. Treatment of anticipated salvage and subrogation.
  - iv. Frequency and quality of reserve reviews.

(3) Audits:

- a. Accountability of management through self-audits or third-party reviews of underwriting and claims processes and practices.
- b. Who performs the audits.
- c. How frequently are the audits performed.
- d. Who reviews the audits.
- e. Outcome of recent audits.

(4) Collateral and Funds Control:

- a. Types of collateral, typically including real estate, letters of credit, credit cards and personal guarantees (including spousal indemnification).
- b. Liquidity of collateral.
- c. Procedure for estimating value of collateral and frequency of valuation.
- d. Process for accepting collateral.
- e. Process when value of collateral declines.
- f. Control and release of collateral.
- g. Utilization of funds control.
- h. Funds control performed in-house or third party.

(5) Other Risk Mitigation Strategies:

- a. Reinsurance:
  - i. Reinsurer credit quality and capacity.
  - ii. Reinsurer expertise in surety.
  - iii. Frequency and quality of claim and underwriting audits performed by reinsurers.
  - iv. Type of reinsurance provided.
  - v. Recent changes in reinsurers or type of reinsurance provided.
  - vi. Dependence on reinsurance for capacity.
- b. Cosurety:
  - i. Procedure for using and selecting another insurer as a cosurety.
  - ii. Expertise, credit quality and capacity of the cosurety.
  - iii. Surety insurer's liability in event of cosurety default.
- c. Joint venture:
  - i. Policies and procedures for instances when multiple contractors are completing a project together.
  - ii. Surety insurer's liability if one of the contractors fails to perform its obligations.

**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. When evaluating a bail bond writer, additional information is requested regarding the ways in which agents are appointed, managed and monitored, especially regarding powers of attorney.

**Bail bonds** are unique in that bail agents are contractually obligated to make sure the criminal defendant appears in court at the proper time. Generally, the gross premium paid by the

defendant for a bail bond is 10% of the bond limit. Since the bail agent is the insurer's first line of defense against potential loss, the agent typically receives a commission of approximately 90% of the gross premium so that the agent has the financial resources to assure compliance with the court. Since 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 state, some bail insurers are required to report their premiums net of commissions, while others are required to report it gross of commissions. This has implications for how A.M. Best treats premium in its Best's Capital Adequacy Ratio (BCAR)

## Exhibit 1

### Sample Capital Factor Calculations for Bail

Based on underwriting profit (excludes investment income).

#### Sample Highly Profitable Company

| Written Premium Net of Commission (\$) | Bail Bond Written Premium Capital Factors   |   |  |
|--|---|---|--|
|  | (1)<br>Industry Baseline NWP Capital Factor | (2)<br>Underwriting Profitability Factor* | (3)<br>= (1) * (2)<br>Final NWP Capital Factor |
| NWP < 1 million                        | 0.80  | 0.80                                      | 0.64   |
| 1m <= NWP < 2m                         | 0.70  | 0.80                                      | 0.56   |
| 2m <= NWP < 3m                         | 0.60  | 0.80                                      | 0.48   |
| 3m <= NWP < 4m                         | 0.50  | 0.80                                      | 0.40   |
| NWP >= 5m                              | 0.40  | 0.80                                      | 0.32   |

#### Sample Unprofitable Company

| Written Premium Net of Commission (\$) | Bail Bond Written Premium Capital Factors   |   |  |
|--|---|---|--|
|  | (1)<br>Industry Baseline NWP Capital Factor | (2)<br>Underwriting Profitability Factor* | (3)<br>= (1) * (2)<br>Final NWP Capital Factor |
| NWP < 1 million                        | 0.80  | 1.20                                      | 0.96   |
| 1m <= NWP < 2m                         | 0.70  | 1.20                                      | 0.84   |
| 2m <= NWP < 3m                         | 0.60  | 1.20                                      | 0.72   |
| 3m <= NWP < 4m                         | 0.50  | 1.20                                      | 0.60   |
| NWP >= 5m                              | 0.40  | 1.20                                      | 0.48   |

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

model. In an effort to ensure consistent treatment of bail bond insurers, A.M. Best will use the bail bond premium written net of commission as the basis for determining required capital for pricing risk on the premium risk page in BCAR. For U.S. insurers, this can be obtained from the Bail Bond Supplement in the statutory statement, provided it is completed accurately. The capital factors applied to the net premium will vary according to the size of net premium and profitability of the bail bond business. A sample calculation is shown in **Exhibit 1**. The benefit to using the net premium is that it reflects the relative net exposure of insurers using a managing general agency (MGA) structure versus those that do not. Bail bond insurers using 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.

Bail agents set aside a portion of their commission income in build-up funds (BUF) that the insurer has access to in the event an agent is unable to meet its obligations. For some insurers, the aggregate amount of BUF accounts can be sizable. It also can distort the balance sheet, as many bail companies record the BUF accounts as both a noninvested 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 fund liability. Since this liability is supported by noninvested assets, it is important to remove the impact from this ratio to get a better view of the insurer's balance sheet liquidity. It should be noted that BUF accounts are not commingled and as a result, an insurer cannot reduce losses from one agency by using BUF accumulated by another agency.

Another divergence from traditional P/C ratios is in the loss, expense and combined ratios. Bail insurers typically have very low losses, as they are absorbed by the agents (through the BUF). As a result, loss ratios for the insurer tend to be less than 10 on average for bail writers rated by A.M. Best. 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 also will look at that agency's expense structure and operating results to determine whether potential losses at that entity might spill over to the insurer in the form of demand for capital (through common ownership).

### Premium Taxes

The issue of using premiums gross or net of commissions has evidently spilled over into the payment of premium taxes. Bail insurers face potential liabilities for premium tax payments. In the few states 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. The analyst needs to find out whether the insurer has taken steps to mitigate this exposure to prevent being fined. A reduction to surplus may be necessary in the insurer's BCAR for this potential liability if the insurer has not accrued an estimated liability on its own.

### Capitalization

As part of evaluating capitalization of contract surety writers and bail bond insurers, A.M. Best will include a reduction to reported surplus in the published BCAR due to a potential large loss.

For contract surety writers, the potential large loss will be the largest net after-tax loss, selected from the surety's 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 will be based on the total bond limits for each principal, where total bond limits equals the sum of in-force bond limits plus the sum of all bond limits expired in the past 12 months. A sample calculation of the net after-tax loss is shown in **Exhibit 2**.

## Exhibit 2

### Sample Calculation of Potential Losses for Contract Surety

Amounts shown in whole dollars. 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.

|  | (1)<br>Largest<br>Exposure | (2)<br>2nd-Largest<br>Exposure | (3)<br>3rd-Largest<br>Exposure | (4)<br>4th-Largest<br>Exposure | (5)<br>5th-Largest<br>Exposure |
|--|----------------------------|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| 1 Gross Exposure for Principal   | \$ 10,000,000              | \$ 7,000,000                   | \$ 5,000,000                   | \$ 3,000,000                   | \$2,000,000                    |
| 2 Loss Severity Model 90% PML Factor                                   | 0.15                       | 0.30                           | 0.16                           | 0.25                           | 0.40                           |
| <b>3 Loss Severity Model 90% PML Amount = (1) * (2)</b>                | <b>1,500,000</b>           | <b>2,100,000</b>               | <b>800,000</b>                 | <b>750,000</b>                 | <b>800,000</b>                 |
| 4 Co-surety's Share %  | 40.0                       | 20.0                           | 0.0                            | 0.0                            | 0.0                            |
| 5 Co-surety's Share Amount = (3) * (4)                                 | 600,000                    | 420,000                        | -                              | -                              | -                              |
| <b>6 Net PML Amount after Co-surety = (3) - (5)</b>                    | <b>900,000</b>             | <b>1,680,000</b>               | <b>800,000</b>                 | <b>750,000</b>                 | <b>800,000</b>                 |
| 7 Acceptable* Collateral Amount  | 300,000                    | 180,000                        | 100,000                        | 150,000                        | 50,000                         |
| <b>8 Net PML Amount after Co-surety &amp; Collateral = (6) - (7)</b>   | <b>600,000</b>             | <b>1,500,000</b>               | <b>700,000</b>                 | <b>600,000</b>                 | <b>750,000</b>                 |
| 9 XOL Reinsurance Amount   | -                          | 500,000                        | -                              | -                              | -                              |
| 10 Quota Share Reinsurance Amount                                      | 120,000                    | 200,000                        | 140,000                        | 120,000                        | 150,000                        |
| <b>11 Pretax Net Potential Loss Amount = (8) - (9) - (10)</b>          | <b>480,000</b>             | <b>800,000</b>                 | <b>560,000</b>                 | <b>480,000</b>                 | <b>600,000</b>                 |
| 12 Federal Tax Rate  | 35.0                       | 35.0                           | 35.0                           | 35.0                           | 35.0                           |
| <b>13 After-Tax Net Potential Loss Amount = ( 100% - (12) ) * (11)</b> | <b>\$ 312,000</b>          | <b>\$ 520,000</b>              | <b>\$ 364,000</b>              | <b>\$ 312,000</b>              | <b>\$ 390,000</b>              |
|  |                            | Largest After-Tax Net Loss     |                                |                                | 2nd-Largest After-Tax Net Loss |

\*Collateral must be easily and quickly convertible into cash.

For surety writers whose largest exposures are located outside the United States, potential large losses will be developed based on information provided by the surety company pertaining to its largest exposures, including open limits, limits expired in the past 12 months, cost to complete, historical large losses incurred, reinsurance program, co-sureties, etc.

In addition, A.M. Best will perform a stress test on the contract surety's BCAR. A stressed BCAR will be calculated by assuming the largest net loss occurred and then estimating what the insurer's BCAR would look like shortly after that first event occurred. This results in a reduction to reported surplus in the amount of the largest net loss (after tax), 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 (after tax) 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. The stressed BCAR will be examined and discussed with the company but will not be published.

For non-construction commercial surety portfolios, if the portfolio contains several large potential loss exposures, then the portfolio will be evaluated in a manner similar to construction contract exposures by estimating a potential large net loss for each large exposure and using the largest potential losses in the BCAR analyses. However, if the exposures are smaller and more effectively analyzed on an aggregate basis, then the aggregate exposure will be considered using an approach that is similar to the approach used on other P/C lines of business where non-catastrophe premium and reserve risks are captured through the use of capital factors in BCAR.

In a similar fashion for bail insurers, A.M. Best will gather information on the five largest bail agents producing business for the insurer. The open liability amount will be used to determine which agents are the five largest producing agents. For each of the top five bail agents, the open liability will be adjusted down to approximate the true current open liability, as the open liability reported by the insurer typically is overstated because of 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 BUF held for that agent are used to reduce the agent's loss exposure. The result will be tax effected. The largest net after-tax amount from those five agents will be used as a potential loss in the published BCAR, resulting in a reduction to reported surplus. A sample calculation of the net after-tax loss is shown in **Exhibit 3**. A.M. Best also will review the insurer's current and historical total forfeitures to determine whether the amounts calculated for the top five agents need to be adjusted.

### Exhibit 3

#### 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 | FIT Rate (%) | After-Tax Net Exposure |                        |
|-----------------|-------------------------|----------------|----------------------------------|-------------------------|-------------|----------------|--------------------|----------------------|--------------|------------------------|------------------------|
| Agent 1         | \$1,000,000             | 50             | \$500,000                        | \$15,000                | \$10,000    | \$5,000        | \$2,000            | \$3,000              | 35           | \$1,950                | = 2nd-Largest Net Loss |
| Agent 2         | 500,000                 | 50             | 250,000                          | 7,500                   | 2,000       | 5,500          | 2,200              | 3,300                | 35           | 2,145                  | = Largest Net Loss     |
| Agent 3         | 300,000                 | 50             | 150,000                          | 4,500                   | 1,000       | 3,500          | 1,400              | 2,100                | 35           | 1,365                  |                        |
| Agent 4         | 200,000                 | 50             | 100,000                          | 3,000                   | 500         | 2,500          | 1,000              | 1,500                | 35           | 975                    |                        |
| Agent 5         | 100,000                 | 50             | 50,000                           | 1,500                   | 200         | 1,300          | 520                | 780                  | 35           | 507                    |                        |

In addition, A.M. Best will perform a stress test on the bail insurer's BCAR. A stressed BCAR will be calculated by assuming the largest net loss occurred and then estimating what the insurer's BCAR would look like shortly after that first event occurred. This results in a reduction to reported surplus in the amount of the largest net loss (after tax), 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 (after tax) calculated from the five largest agents. The 40% factor may be adjusted up or down by the analyst based on the reinsurance contracts in place. The stressed BCAR will be examined and discussed with the company but will not be published.

While these stress tests will represent A.M. Best's typical stress testing for contract surety and bail insurers, the analyst may determine that additional testing and/or adjustments to the above tests



are appropriate. If an insurer writes both contract surety and bail, the potential losses used in BCAR will be from the calculations generating the higher potential losses. As long as the stressed BCAR does not fall more than 30 points below the BCAR guidelines for the rating, there likely will be no rating pressure from the stress test. For those insurers that write other lines of business that are exposed to other, uncorrelated catastrophe losses, the potential large losses used in BCAR will be the higher of surety, bail, catastrophe or other potential or actual recent large losses.

## Exhibit 4

### Sample Adjustments in BCAR for Contract Surety

Based on sample data in Exhibit 2.

(USD Thousands)

| <b>Adjustments in Published BCAR:</b> |               |   |
|---------------------------------------|---------------|---|
|                                       | <b>Amount</b> | <b>Description</b>  |
| Reduction to Reported Surplus:        | 520           | Largest after-tax net loss (from Exhibit 2, Column 2, Line 13)                                      |
| <b>Adjustments in Stressed BCAR:</b>  |               |   |
|                                       | <b>Amount</b> | <b>Description</b>  |
| Reduction to Reported Surplus:        | 520           | Largest after-tax net loss (from Exhibit 2, Column 2, Line 13)                                      |
|                                       | 390           | 2nd-largest after-tax net loss (from Exhibit 2, Column 5, Line 13)                                  |
|                                       | 910           | Total reduction to surplus  |
| Increase to Recoverables:             | 448           | 40% of losses ceded to reinsurers & co-surety on largest net loss*<br>= 40% times (420 + 500 + 200) |
|                                       |               | = 40% times (Exhibit 2, Column 2, Lines 5, 9 and 10)  |
|                                       |               |   |
| Increase to Net Loss Reserves:        | 320           | 40% of largest pretax net loss<br>= 40% times 800   |
|                                       |               | = 40% times (Exhibit 2, Column 2, Line 11)  |
|                                       |               |   |

\* Assumes surety is contingently liable for co-surety's share of loss. If surety is not contingently liable, then the co-surety's share will be removed.

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## METHODOLOGY

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