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Rating Members Of Insurance Groups

The purpose of this criteria procedure is to illustrate how A.M. Best evaluates members of insurance groups and to review what levels of rating enhancement or drag are placed on the ratings of members of insurance groups. If a company is owned, affiliated or controlled by another organization that consists of more than one insurance company, then it may be considered a member of that group. The financial data of insurance companies within a group can be combined for analytical purposes if its inclusion is needed to ensure completeness of the potential risk to the enterprise's financial strength. 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.

Analyzing Groups

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 looked at 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 assessment is determined for all entities except those that possess a pooled or reinsured rating. A.M. Best's approach to rating pool members and reinsured affiliates is discussed later.

In cases where it is inconceivable for an insurer to exist without its membership within a larger organization (i.e. there would be no business to write without the parent company, as with a small subsidiary that exists solely for rate flexibility), a review of balance sheet strength and historic operating performance drives the stand-alone approach. Here, less emphasis is placed on the qualitative components of business profile – such as competitive market advantage, brand-name recognition and control of distribution – for the purposes of the stand-alone assessment.

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. Key questions may include:

- What resources are available to the organization as a whole in relation to its cumulative current and future financial obligations?

- What available excess capital can the group employ to support individual subsidiaries?

Note that A.M. Best defines excess capital as the difference between available capital and the required capital that must be in place to adequately support the organization's risks.

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This top-down analysis highlights the benefit of diversification within an insurance group. Because of the less than complete correlation of individual risks, the total required capital at the consolidated group level is invariably less than the sum of its parts. As such, group capitalization, particularly where there is excess capital, can have a direct effect on subsidiaries' capital requirements and ratings. Nevertheless, A.M. Best expects a certain minimum level of capitalization will be maintained at the insurance company level.

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 assessments.

Overview of Rating Enhancement/Drag

To be eligible for rating enhancement, the insurance subsidiary must operate under common ownership (greater than 50%) with the entity providing lift or maintain board control together with common management. An individual company can receive enhancement to its rating through support from its parent or from affiliated companies. This support can be explicit, such as through a guarantee, reinsurance agreement, capital infusion or pooling of assets and liabilities. Alternatively, it can be implicit support that ties the importance of the company to the overall organization. For example, a company or operating unit might provide important strategic or financial benefit to the organization's core operations, or it might in itself be an integral part of the group's core operation.

Existing reinsurance protection from a parent or affiliated company, or a prior capital infusion, is considered in the stand-alone analysis of the operating unit. However, the permanence of any capital contribution or reinsurance protection is an important aspect of any explicit support. As a result, the evaluation of explicit support must include a subjective review of the expected permanence of parental commitment to its subsidiary.

For this reason, Best's Ratings that incorporate parental support require ongoing surveillance to ensure there are no material changes to the degree of implicit and/or explicit parental support. As with all Best's Credit Ratings, the dynamics of each insurance group are re-evaluated continually for changes that might arise. A.M. Best maintains contact with company management throughout the year and monitors each company's performance and its strategic role within its group.

Implicit Parental Support

Overview

A.M. Best considers operating subsidiaries within a group for rating enhancement ranging from none to full rating enhancement. In the latter case, the company is assigned its parent's rating – assuming the parent providing lift is an insurer itself. In cases where the lift comes from a parent holding company (intermediate or ultimate) or a non-insurance affiliate, full rating enhancement would lift the stand-alone assessment to the lead insurance company's rating, which was determined through the enterprise-level analysis. In either case, lift is determined in the same way. Throughout this criteria procedure, either case will be referred to as the subsidiary receiving its parent's rating.

Companies that receive full rating enhancement maintain a strong affiliation with, or importance to, the parent. A.M. Best deems the security offered to the policyholders of these subsidiaries to be as strong as that offered to any policyholder within the group. Companies that receive no rating enhancement demonstrate the least strategic importance and potentially could cease operations or be sold with no material impact on the group's future success. These companies could be assigned ratings no higher than their stand-alone assessments, unless new, explicit support is provided. Regardless of the subsidiary's perceived importance to the group, any subsidiary company's published rating could be lowered from its stand-alone assessment if there is a perceived drag from a weaker parent or affiliate.

Consideration of rating enhancement is based primarily on the level of implicit support expected from a parent or affiliate. However, the amount of explicit support already provided to the operating unit also influences the level of implicit support anticipated by A.M. Best and the level of benefit in a rating. These judgments are subjective and are decided by a rating committee following a formal rating review, which includes detailed discussions with management to gain a complete understanding of the organization, its individual members and the markets in which they operate.

There is no automatic increase in the subsidiary's published rating. A.M. Best determines the amount of enhancement provided in the published rating, if any, after considering the:

- Subsidiary's level of strategic importance to the parent.

- Subsidiary's integration within the group's operations.

- Differential between the subsidiary's stand-alone assessment and the parent's rating.

- Level of the parent's rating.

- Trends in the parent's and subsidiary's stand-alone assessments.

- Level of the subsidiary's stand-alone assessment.

- Amount of explicit support provided to date.

When a parent company's financial strength diminishes due to a shock loss or negative market event, clearly its ability to provide support to its subsidiaries also is reduced. If the parent's financial health were to deteriorate precipitously, particularly in cases where excess capital within the organization was to evaporate, any rating enhancement afforded to affiliates or subsidiaries would be reduced or eliminated. In extreme cases, an impaired insurance company's ability to support its subsidiaries might be severely limited by regulatory restrictions. A.M. Best seeks to identify the potential for this in its analysis of rating enhancement and will remove rating uplift emanating from an unstable parent company.

In some cases, a subsidiary meets the criteria for rating enhancement, but its stand-alone assessment and published rating remain the same (e.g. A- stable outlook to A- positive outlook). Generally, the maximum benefit a stand-alone assessment can achieve through implicit support is two Financial Strength Rating levels (e.g., B+ to A-). However, additional lift is possible through explicit parental support (e.g., guarantee, net worth maintenance agreement). Examples of these and other situations will follow in the next section.

Implicit Support – Full Rating Enhancement

A subsidiary is assigned its parent's rating (i.e. given full rating enhancement) if A.M. Best views the company to be integral to the group's primary business through its financial, operational and/or strategic importance. A.M. Best expects that under almost any scenario, the parent would continue to support the subsidiary to the extent of its financial ability. The sale or closure of such a subsidiary would imply an unexpected shift in the group's strategy. As a result, these subsidiaries are assigned the parent's rating and financial size category.

The operating performance of the subsidiary and its ability to meet A.M. Best's expectations are important in evaluating the rating enhancement. **Exhibit 1** details common characteristics of a subsidiary that is assigned its parent's rating.

As a matter of course, it is very unlikely that a newly started or acquired entity would be eligible for its parent's rating based on implicit support until it had demonstrated its contribution to the group's earnings. Therefore, a start-up would need explicit parental support (i.e. affiliated reinsurance, financial guarantee, etc.) to achieve substantial rating lift. For an example of full rating enhancement, please see **Appendix A**.

Implicit Support – Partial Rating Enhancement

The degree of affinity between subsidiary and parent differentiates those subsidiaries that receive the parent's rating from those that receive partial rating enhancement. The willingness of the parent to incur the financial impact of supporting such a subsidiary under stress is less certain. The subsidiary is not essential to the organization's success, and the sale or run-off of the operation would not imply a radical change in core business strategy. Nonetheless, A.M. Best believes the subsidiary is important enough to the organization that the parent would incur losses substantially greater than its legal obligation to keep the subsidiary in good financial standing.

The subsidiary's operating performance and its ability to meet A.M. Best's expectations are important considerations in assigning partial rating enhancement. Common characteristics of a subsidiary that is assigned partial rating enhancement are listed in **Exhibit 2.**

A subsidiary assigned partial rating enhancement can achieve a rating at the same level as its parent, but this rating still is considered a separate rating. As such, it does not maintain the parent's financial size category. Another key difference is that companies receiving full rating enhancement move up or down in lockstep with the parent. Partial rating enhancement that brings the subsidiary's rating to its parent's level does not imply that if the parent's rating goes up, so will the subsidiary's. In this case, the subsidiary's stand-alone assessment likely would have to improve, or its perceived level of implicit parental support would have to increase, before the subsidiary could receive an upgrade. **Appendix A** shows an example of a subsidiary that receives partial rating enhancement as a result of implicit parental support.

Exhibit 1
Full Rating Enhancement Factors

Key issues relating to full rating enhancement include:

- Is critical to the group's strategy and ongoing success.
- Is fully integrated into the group's strategic plan.
- Carries the group name or is identified easily with the group.
- Is material to the business profile of the group.
- Is a significant contributor to the group's earnings.
- Currently benefits from some form of explicit parental support.
- Has a history of receiving explicit support when needed.
- Is necessary for rate flexibility.
- Is necessary for licensing.

Implicit Support – No Rating Enhancement

A subsidiary receiving no rating enhancement is viewed as a company that is an investment and not a key component of the group's long-term strategy. In these instances, the operating unit would be assigned a rating equal to its stand-alone assessment. Common characteristics of a subsidiary that receives no rating enhancement are detailed under **Exhibit 3**.

It is important to note that a subsidiary may represent a successful investment but still receive no rating enhancement. However, the subsidiary's stand-alone assessment would reflect its success. For an example of a subsidiary receiving no rating enhancement, please see **Appendix A**.

Capital Requirements for Subsidiaries

When reviewing an insurance subsidiary, A.M. Best determines the minimum level of capital the subsidiary must hold to maintain the rating. If there are restrictions on the free flow of capital, a greater capital requirement may exist at the subsidiary level. Several factors weigh into the capital requirement, including the:

- Subsidiary's historic and prospective performance.
- Risk appetite and shock-loss exposure.
- History of parental support
- Perceived future parental support.
- Fungibility of capital between the parent and subsidiary.

A.M. Best takes a similar approach to its capital requirements at the subsidiary level. The required capital level can be determined by Best's Capital Adequacy Ratio (BCAR) or by the prudential regulatory authority in countries deemed to have strong insurance regulation. The subsidiary's level of capital plays a leading role in the assignment of the stand-alone assessment and also helps determine the potential for rating enhancement. Typically, the maximum rating enhancement through implicit support is two FSR levels.

Companies that receive more than two FSR levels of lift are generally deeply integrated in the group's operations or hold a comprehensive financial guarantee or net worth maintenance agreement from the parent. In these cases, the subsidiary can attain the parent's rating level due to its integration within the group's operations, where the spread between the stand-alone assessment and published rating is greater than two levels. For more information on how explicit support such as parental guarantees and net worth maintenance agreements factor into rating enhancement, please see below. A.M. Best also conducts its BCAR analysis at

Exhibit 2
Partial Rating Enhancement Factors

Key issues relating to partial rating enhancement include:

- Is important to the group's business strategy and profile.
- May operate on a more independent basis, such as through a separate identity or distribution platform.
- Has earnings that are not core to the group but are a good source of diversification.
- Is a meaningful contributor to the group's operating performance and/or financial strength.
- Has benefited from some form of explicit parental support.
- Is highly likely to receive future support.

Exhibit 3
No Rating Enhancement Factors

A subsidiary that receives no rating enhancement is one that:

- Has marginal or incidental status to the group's overall strategy.
- Can be readily sold without material impact to the group's ongoing operations.
- Has a separate operating platform.
- Is managed independently with a separate market identity.
- Lacks business synergy with parent's core operations.
- Provides no meaningful diversification benefits.
- Is not a significant contributor to earnings or capital.

the consolidated group level to ensure that sufficient capital exists in aggregate and to cover all subsidiaries' capital requirements.

Non-Insurance Parent or Affiliate

To rate individual insurance companies within a group, A.M. Best takes a top-down analytical approach, meaning it needs to analyze and understand the organization as a whole. Here, A.M. Best reviews the parent holding company to capture the entire group's performance and capital position. At this level, financial leverage and fixed charge coverage, liquidity, and asset quality and diversification, among others, are reviewed to ensure that the group, as a whole, is in good financial standing. This analysis helps determine the highest possible rating for any insurer within the group based on lift. Also, if the entity issues debt or hybrid securities to the public market, A.M. Best analyzes and rates these securities.

The purpose of the top-down approach is primarily to determine whether or not the parent company, or indirectly a non-insurance affiliate, is in a position to provide lift or drag to the rated insurance entities. For example, a group may have a manufacturing subsidiary that provides substantial earnings to the group. In addition, this entity may hold excess capital that could be made available to the insurance entities if necessary. Ready access to this affiliate's excess capital, plus the benefit of a diversified stream of earnings to the entire group, could provide lift to the stand-alone assessments.

Conversely, for a group with a premium finance affiliate that is depleting group capital due to excessive charge-offs, the insurers' ratings likely would be affected adversely by this affiliate that is draining the group's financial resources and hurting consolidated earnings.

A.M. Best reviews all members of a group for the potential benefit or drag an affiliate can represent. To gain comfort with a group's non-insurance affiliates, A.M. Best's analysts hold discussions with management to determine these entities' strategic fit. A review of these entities' stand-alone performance, balance sheet and risk appetite determines their contribution to the group relative to the other operations. Additionally, A.M. Best's analysts use public information, third-party analytical studies and industry reports, as well as their own analysis of management-provided information, to assess a non-insurance affiliate's financial condition.

Explicit Financial Support

Explicit financial support demonstrates a group's commitment to a subsidiary or affiliate. Such support comes in the form of a capital contribution or a contractual arrangement that exhibits the parental commitment, regardless of the subsidiary's fundamental importance to the group. Pooling, internal reinsurance, guarantees and net worth maintenance agreements are examples of explicit support. In many cases, insurance groups use these tools to facilitate capital management by reducing the need to capitalize each subsidiary at a level consistent with their risk exposure before the contractual support.

The level of benefit afforded to an operating unit's rating depends on the type of explicit financial support provided. Insurers with pooled or affiliated reinsurance arrangements meeting A.M. Best's requirements are assigned the parent's rating. Guarantees, also discussed below, that offer full protection to a subsidiary can provide rating enhancement, and in some cases equalize the subsidiary's and parent's ratings.

Treatment of Branches

A branch is not a separate legal entity and is viewed as an extension of the head office. As such, policies are written on the paper of the legal entity of which the branch is a part. Therefore, a branch maintains the rating of the head office.

Questions have arisen regarding the treatment of branches based on liquidation preference between the head office policyholders and the branch office policyholders. The ratings apply to all insurance policies issued by an insurer as a single class of obligation. In effect, A.M. Best's rating opinion applies to the last policyholder in a liquidation scenario.

Pooled Affiliations

A group whose member companies pool assets, liabilities and operating results maintains, in theory, the same operating performance and balance sheet strength as other companies within the pool. 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.

Intercompany pooling agreements generally contain the following provisions:

- The agreement among the pooled companies is joint and several.

- The pool is pure, meaning that all premiums, losses and expenses are shared based upon the pooling percentages, with the allocation of each being consistent with the allocation of unstacked surplus among the pool members. Pool percentages may need to be reallocated periodically because of the investment performance and dividend activity of individual pool members.

- Stand-alone capitalization supports the assigned rating after the pool is considered.

- The pool includes coverage for any prior-year loss-reserve development exposure.

- The pool includes coverage for the run-off of all liabilities incurred on policies incepted prior to termination.

- A common, ultimate parent with ownership measured as greater than 50%; or control of the board of directors along with common management of each of the pooled members consistent with the lead company.

- A 12-month notice before the pool can be disbanded or a company can be removed from it.

- A description of the process for removing an individual company from the pool and reallocating liabilities.

Typically, all pool members are assigned the same rating and Financial Size Category, based on their consolidation. Companies that are members of pools that do not qualify for the pooled rating still can qualify for rating enhancement. Depending on the insurer's stand-alone rating and the strength of the pooling arrangement, together with any other explicit and implicit support provided, the insurer can receive the same rating – without the group financial size category – as the other companies within the pool.

Reinsurance Affiliations

The reinsured rating is assigned to a company within a group that reinsures substantially all its insurance risk with an affiliated reinsurer. These intercompany reinsurance agreements generally contain the following provisions:

• Quota share of all premiums, losses and expenses written by the company unless regulatory restrictions apply (A.M. Best requires documentation from the regulator in these cases). In those cases, the retained percentage could be as high as the level required by regulation, to a maximum of 20%, but those cases would be subject to additional review.

• Stand-alone capitalization that supports the assigned rating, after consideration of the affiliated reinsurance and the incorporation of credit risk. For those companies with less than a 100% quota share, stand-alone operating performance also is considered in the analysis.

• A contract that contains no loss caps or loss corridors.

• 12 months' notice required before the reinsurance can be terminated.

• Reinsurance contract includes coverage for the runoff of all liabilities incurred on policies incepted prior to termination.

• Coverage for any prior-year loss reserve-development exposure through the reinsurance arrangement.

• The assuming company has common ultimate ownership with the reinsured company, or common control through the board of directors together with common management.

Typically, reinsured affiliates are assigned the same rating and Financial Size Category as their reinsurer. Companies that do not qualify for the reinsured rating still may qualify for rating enhancement. Depending on the strength of the reinsurance contract and any other explicit and implicit support provided, the insurer can receive the same rating as the affiliate or parent company providing the reinsurance.

Guarantees

The use of guarantees to show explicit support for a subsidiary's financial obligations has grown in recent years as groups optimize the efficient allocation of capital. A fully enforceable guarantee could protect the subsidiaries' policyholders without a potentially large, upfront capital infusion from the parent. However, the enforceability of guarantees – particularly those covering a large, geographically diverse population of policyholders – is always a concern.

Guarantees that result in rating enhancement generally contain:

• Coverage for all financial obligations of the subsidiary.

• A clear and satisfactory resolution to any foreseeable regulatory/jurisdictional conflicts.

• A termination notice of at least 12 months.

• Public disclosure of the guarantee.

• An assurance of enforceability, allowing policyholders/claimants to enforce the guarantee directly and locally within their own jurisdictions.

• Run-off coverage preserved for liabilities incurred on policies incepted prior to termination.

The mechanics and authority for triggering the guarantee must be clear. Also, in some cases, a third-party legal opinion on the enforceability of a guarantee may be necessary for the guarantee to be considered for rating lift. It is important that the legal opinion address all regulatory and legal issues in each domicile that reasonably could apply to the guarantee.

If the above-noted factors are present, it is possible for a subsidiary to obtain its guarantor's rating. The rating committee determines the application of full rating enhancement, based on the factors noted in the above section titled "Implicit Support – Full Rating Enhancement."

Guarantees that are not ironclad are given consideration as explicit support and can still enhance the published rating. These guarantees, however, do not merit full rating enhancement up to the guarantor's rating level. Also, the guarantor's capacity to make good on a guarantee is considered in the guarantor's rating.

Other Financial Support

A.M. Best evaluates other types of financial support – such as net-worth maintenance, stop-loss reinsurance and keep-well agreements – as part of the rating enhancement, so long as they are not evident in the company's financial performance. Once these support mechanisms are utilized, they become part of the stand-alone assessment.

Key factors that would result in favorable treatment by A.M. Best include:

• A contract without loss caps or loss corridors.

• A termination notice of at least 12 months.

• Run-off coverage that is guaranteed for the duration of the run-off of liabilities incurred on policies incepted prior to termination.

• Coverage for any prior-year loss-reserve development included in the protection.

• A clear confirmation of ability and willingness of minority owners to participate in the protection if the company providing the protection does not have 100% ownership.

Insurance Groups With Lloyd's Operations

The rating process for groups with a Lloyd's platform is substantially the same as it is for all insurance groups. However, the unique capital structure and practices of the Lloyd's market introduce distinct issues, particularly in respect of the analytical treatment of group capital used to support underwriting at Lloyd's.

A.M. Best's fundamental rating approach for the assignment of a rating to a member or holding company of a group is to examine an organization from both the top down and the bottom up to incorporate an assessment of all material sources of risk to each rated entity.

An insurance group writing business at Lloyd's typically will own a corporate member, which participates in the Lloyd's market through the provision of capacity to one or more syndicates. It accepts insurance business through syndicates on a several basis for its own profit and loss and holds the capital supporting its share of business written in the form of funds at Lloyd's (FAL). For such groups, both the performance of and the capital supporting business written at Lloyd's are captured in the top-down consolidated analysis via the corporate member.

As part of the analysis of a group's consolidated balance sheet strength, A.M. Best uses Best's Capital Adequacy Ratio (BCAR) to calculate the net required capital to support the financial risks of the group (including those of the corporate member) and compares it with the group's available capital (including capital lodged as FAL).

The level of FAL determines the amount of insurance business a member can underwrite at Lloyd's. Consequently, a member unable or unwilling to replenish its FAL will have to reduce the amount of Lloyd's business written. It follows that if FAL are exhausted and will not be replenished, the corporate member will cease underwriting at Lloyd's.

It is noted that if the member's FAL are inadequate to meet syndicate losses, a managing agent may submit a request for Lloyd's to meet the cash call from its central assets. However, A.M. Best gives no capital credit for the access a member's insurance creditors have to Lloyd's central assets within the group's consolidated BCAR analysis. This is primarily because it is only the obligations of the corporate member, not those of the wider group, that may be met by Lloyd's central assets.

A.M. Best's bottom-up analysis of a group's Lloyd's business focuses on an assessment of the risks generated directly by the syndicates in which the corporate member participates. Syndicates are assessed based on A.M. Best's traditional key rating factors – capital strength, operating performance and business profile – taking into account Lloyd's unique capital structure.

Insurance Holding Company Ratings and Lloyd's

The rating of an insurance holding company (IHC) is determined by reference to the ICR of the operating insurer(s) that it primarily depends upon to meet its obligations. It reflects analysis of both the credit risk implications of the IHC being a separate legal entity from the operating insurer(s), and the normal subordination of IHC creditors to operating company policyholders.

For an insurance group with a significant Lloyd's operation, the entity that the holding company most depends on to meet its obligations may be a Lloyd's syndicate. If this is the case, often it is not appropriate to use the syndicate rating in the notching process.

Lloyd's "chain of security" – in particular, the role of the Central Fund, which partly mutualizes capital at a market level – ensures that each Lloyd's syndicate is backed by capital consistent with the financial strength rating of at least that of the Lloyd's market. Consequently, a syndicate rating cannot fall below the Lloyd's market rating.

As Lloyd's central assets are available to meet only the insurance liabilities of the corporate member, when determining the holding company ICR of a group with a significant Lloyd's operation A.M. Best uses its consolidated view of the organization to conduct an enterprise-level analysis. This forms the basis for an overall operating company ICR, which then is used in the notching process rather than a syndicate rating that reflects the financial strength of the Lloyd's market.

Segregation of Capital for Lloyd's Business

Funds at Lloyd's are defined as capital lodged and held in trust at Lloyd's as security for policyholders and to support a member's overall underwriting business. The funds lodged can be investments and cash but are often letters of credit drawn on one or more banks.

Where investments and cash are provided by a group company, or where a letter of credit is backed by collateral from a group company, the assets clearly are encumbered. To reflect the limitations on the transfer of this capital across the group, A.M. Best applies a nominal 1% capital charge to the group's assets that support FAL in the group's consolidated BCAR. This is in line with A.M. Best's baseline treatment of balances associated with noncontrolled assets.

The analyst may increase the asset risk factor beyond the nominal 1% following an evaluation of the likelihood that FAL will be used to pay syndicate losses. The evaluation would take into account the historical and expected performance of the group's Lloyd's business, as well as the potential exposure of this business to large, marketwide losses.

Letters of Credit

Insurance groups commonly use letters of credit (LOCs) to meet their FAL requirements, and these may be either collateralized or uncollateralized. In the case of a collateralized LOC, assets backing the LOC are included in A.M. Best's assessment of a group's available capital, although a capital charge may be applied (see above).

An undrawn, uncollateralized LOC supporting FAL receives no capital credit in a group's consolidated BCAR. The rationale for this treatment is that, if the LOC was to be drawn down, it would become short-term bank debt on the group's balance sheet. A.M. Best does not afford capital credit to short-term bank debt.

However, it is recognized that, under a stress scenario, an uncollateralized LOC could be converted readily to cash to meet the group's Lloyd's obligations. For this reason, the existence of an uncollateralized LOC would be considered in A.M. Best's assessment of the group's financial flexibility and liquidity.

Internal Reinsurance of Lloyd's Business

Within an insurance group, earnings from the group's corporate member often are transferred to another group entity, typically to realize tax efficiencies. This is frequently achieved through quota-share reinsurance, with the group reinsurer providing a share of the corporate member's FAL that matches the proportion of risk assumed. For example, if there is a 50% whole-account quota share in place, the corporate member and reinsurer each may provide 50% of the FAL.

When determining the appropriate treatment in the reinsurer's BCAR of Lloyd's business assumed and FAL lodged to support this business, A.M. Best first will conduct a detailed review of the reinsurance contract in place and the treatment of the risk assumed in the reinsurer's accounts.

If the Lloyd's-related risk is reflected accurately in the reinsurer's balance sheet and income statement – for example, if there is a standard quota share agreement in place – A.M. Best will include the risk associated with this business and the capital supporting this risk (a share of FAL) in its analysis of risk-adjusted capitalization through BCAR. In addition, A.M. Best will conduct BCAR analysis excluding the risk and capital relating to the Lloyd's business.

In circumstances where the proportion of FAL provided by the reinsurer exceeds the proportion of Lloyd's business it assumes, A.M. Best will deduct an amount equal to the excess from capital in the stand-alone analysis of the reinsurer. This is to avoid giving credit for capital that supports risks not captured in the reinsurer's accounts and BCAR.

Occasionally, the transfer of premium and reserve risk to the reinsurer is not reflected in the reinsurer's accounts in a manner that allows A.M. Best to capture the assumed risk accurately in BCAR – for example, if the reinsurance transaction is a quota share of the corporate member's profit/loss. If this is the case, in the absence of additional information, A.M. Best will deduct from available capital an amount equivalent to the reinsurer's share of FAL. Additional adjustments may be made to ensure that neither the Lloyd's-related risk assumed by the reinsurer, nor the capital supporting this risk (FAL), is reflected in BCAR.

As participation in Lloyd's is on a limited-liability basis, the group reinsurer usually is not legally obliged to pay out more than its share of FAL to support its Lloyd's losses. By deducting FAL from available capital, A.M. Best is reflecting the maximum loss that the reinsurer would incur from the assumed Lloyd's business. Any business or reputational issues that may arise if the group is unable or unwilling to replenish its FAL are captured by A.M. Best in the consolidated analysis of the insurance group.

Summary

The starting point for every rating is the stand-alone evaluation of the legal entity's balance sheet strength, operating performance and business profile. This analysis incorporates all in-place financial and operational support provided to the subsidiary from its parent that is evident in the subsidiary's financial results. Rating enhancement refers to provided, but unused, support (e.g. untapped guarantee or stop-loss reinsurance) and the potential for future parental support. Rating enhancement also can be derived from the inherent benefits the subsidiary enjoys simply through being part of a strong, diversified insurance organization (e.g., distribution channels).

A.M. Best understands that in today's dynamic market, being able to allocate capital efficiently is a key competitive advantage. Through this criteria procedure A.M. Best balances the policyholder protection afforded by the stand-alone financial strength of the legal entity, and the good-faith commitment of a parent to support the obligations of its subsidiaries.

A.M. Best believes a balance can be struck between in-place capital at the subsidiary level and a parental commitment to provide additional financial support when needed. A.M. Best encourages insurance organizations to speak to their analysts about their capital management strategies and highlight how each subsidiary operation fits into the group's overall business strategy.

Appendix A

Case Study of Varying Levels of Rating Enhancement Through Implicit Parental Support

A U.S.-headquartered insurance organization operates its global insurance business using three geographically distinct business platforms: London, the United States and Bermuda. The parent holding company in the United States possesses significant excess capital that is available to support its insurance operations. Through A.M. Best's top-down analysis of the consolidated group, the rating committee has determined that the highest possible insurer rating for the lead member of the group is A+. The parent company has expressed its commitment to each profit center, but it is clear that each holds a different level of importance to the overall earnings and business strategy of the group. The following paragraphs detail the unique features of the three business platforms and the important distinctions that drive the assignment of rating enhancement, or lack thereof.

Full Rating Enhancement

The London-based operating platform includes four European insurers located in England, Germany, France and Italy. The English and German carriers are composite insurers that write both life and non-life products, while the French and Italian insurers write life and annuity business. Each insurer is a market leader in its respective country, and together, these four insurance companies generate more than 70% of the group's total revenue and earnings. In addition, these entities employ roughly 50% of the group's capital and thus generate a solid risk-adjusted return. These companies consistently produce strong earnings with minimal volatility, and they are perceived to be at the heart of the parent's global business strategy. Much of the core competencies of the entire group are housed within this business center. As a result, the parent company in the United States has a track record of supporting these companies financially and operationally and has expressed its commitment to do so in the future.

The stand-alone assessment of each of these entities is A. They each are afforded full rating enhancement to the parent's rating of A+, mainly because of their:

- Importance to the parent's global strategy and contribution to its consolidated financial strength.
- History of receiving explicit support when needed.
- Lack of any regulatory restrictions as to the free flow of financial support from the parent.
- Significant excess capital held at the parent company.
- Solid, stand-alone financial strength.

Partial Rating Enhancement

In contrast to the London platform, the U.S. insurance hub consists of a large, national life and annuity company. This company's revenue and earnings comprise slightly more than 20% of the group's total, although it has experienced some negative swings in earnings in prior years due to its annuity products. This entity's required capital is 25% of the total group's required capital. The U.S. company operates under the same brand name as its affiliates in France and Italy and shares many back-office and product-development functions with these entities. There is cross representation with regard to the board members of these three entities, and management at the parent holding company has expressed its commitment to this U.S. entity. Even so, it is clear that this entity is of secondary importance to the stronger-performing European operations.

The current stand-alone assessment of the U.S. entity is A- because of its solid capital position and well-established business profile, which are offset in part by a history of volatile earnings. The rating enhancement results in a published rating of A. The rationale for only giving partial rating enhancement is that the operation is deemed nonessential to the global business plan, and performance has been subpar in relation to the strong earnings generated by the European operations. And although the subsidiary does not qualify for full rating lift, it does receive partial lift because it:

- Is integrated with the business of the lead life and annuity writers.
- Is a material provider of earnings to the group.
- Carries the same brand name.
- Has close operational ties to the European life companies.

No Rating Enhancement

The third platform consists of a Bermuda property catastrophe reinsurer. In a good year, this entity comprises only 10% of revenue and earnings, but operating losses have been reported in three of the past five years. Because of the shock-loss exposure inherent in writing property catastrophe reinsurance, the capital allocated to this operation is high, roughly 25% of the group's required capital. This entity operates independently from the group, and from a brand name perspective is not immediately recognizable as a member of the group. Management of the parent company has stated that it stands behind all of its insurance operations, but also has told A.M. Best that the plan is to spin off this entity within the next two to three years. In addition, management has expressed distaste for the volatile earnings generated by this operation. The stand-alone assessment of this entity is A- based on its very strong balance sheet, which is offset in part by a limited business profile and generally volatile earnings. This entity receives no rating enhancement because it is:

- Considered an investment by management with intent to sell in the near term.
- Not key to the group's global business strategy.
- Not a significant provider of earnings to the group.

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