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Draft: BCAR for Title Insurance Companies

Introduction to A.M. Best Rating Process

Contents

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This publication updates the criteria report issued March 8, 2012 and specifies that premium capital factors will be adjusted based on a company's premium volume (pages 4, 9 and 11), and reserve capital factors will be adjusted based on the size of a company's loss and loss-adjustment expense reserve liability (pages 4, 9 and 10). In addition, the year-end reserve data used to calculate the industry baseline reserve capital factor was increased from five years of data to seven years of data (pages 9 and 10), and the industry baseline premium capital factor uses 10 years of data (page 11). This update also includes the potential for higher asset risk charges for foreign investments (page 4), a change in the discount rate assumption used to present value loss and LAE reserves from 5% to 4% (page 10), and a description of typical items that are included in off-balance sheet risk (page 4).

A.M. Best's interactive rating process for title insurance companies is intended to provide an opinion on a company's ability to meet its ongoing obligations to policyholders. The evaluation of a company's financial strength is based on an in-depth analysis of its balance sheet strength, operating performance and business profile. These three components then are compared with A.M. Best's quantitative benchmarks and qualitative standards to assign financial strength (FSR) and issuer credit (ICR) ratings.

While it is only one of the three components of a title insurance company's rating, balance sheet strength represents the foundation of a company's financial strength. A key component of an evaluation of balance sheet strength is a company's Best's Capital Adequacy Ratio (BCAR), which evaluates and quantifies the adequacy of a company's risk-adjusted capital position. The purpose of this paper is to explain the components of the BCAR; its role in the determination of balance sheet strength; and its impact on the overall rating of a title insurer.

Balance Sheet Strength

In determining a company's ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its balance sheet strength, since it is the foundation for policyholder security. The primary objective of an evaluation of balance sheet strength is to determine the exposure of a company's surplus to operating and financial risks.

Measurement and analysis of a title insurer's underwriting, asset and financial leverage are key components to determining its overall balance sheet strength. Even though a highly leveraged company can demonstrate highly favorable rates of return on surplus, it also may be exposed to a greater degree of volatility in its earnings and may be hindered in its ability to withstand financial and market risk events. Companies that are more conservatively leveraged, however, may not show high rates of return on surplus but generally produce earnings that are less volatile and are generally better able to manage risks to surplus.

In measuring leverage ratios for title insurers, A.M. Best recognizes that because of statutory premium reserve requirements as mandated by title insurance regulators in most states, reported surplus may be understated, which results in inflated leverage measures. Ratios therefore are calculated on the basis of both reported surplus and surplus adjusted for statutory premium reserves in excess of incurred but not reported (IBNR) reserves when evaluating underwriting, asset and financial leverage. Leverage ratios on a reported basis tend to be significantly higher than those measured on an adjusted basis.

Underwriting leverage is a measure of the exposure of a company's surplus to its underwriting risks, which includes underpricing of its book of business and underestimation of its loss and loss-adjustment expense reserves. Underwriting leverage is generated from current premium writings, loss reserves and reinsurance recoverables. To assess the appropriateness of a company's underwriting leverage, consideration also is given to its geographic spread of risk and distribution mix (agency versus direct distribution).

Since title insurance is a loss-prevention line of business, title insurers often maintain high premium leverage.

Asset leverage measures the exposure of a title insurer's surplus to investment, credit and interest-rate risks. These leverage measures take into account the credit quality, market volatility and asset class concentration of a title insurer's investment portfolio and its impact on balance sheet strength.

Financial leverage is created through debt or debt-like instruments and measures what impact the repayment of these securities can have on a title insurer's earnings and future cash flow. Common measures of financial leverage include debt-to-capital and debt-to-equity ratios, as well as coverage ratios, which measure the extent to which a company's earnings and cash flow cover interest payments and other fixed obligations. An analysis of financial leverage also is conducted at the holding-company level, since debt at the holding company can reduce financial flexibility and place greater strain on an operating entity's future earnings and surplus growth.

A company's underwriting and asset leverage also are subjected to an evaluation by Best's Capital Adequacy Ratio (BCAR), which allows for an integrated review of these leverage measures. BCAR calculates the net required capital to support risks associated with the exposure of assets and underwriting to adverse economic and market conditions, and compares it with capital adjusted to reflect an economic basis. A.M. Best also conducts stress tests within the BCAR framework that measure the impact of economic "shock events," such as a sharp rise in mortgage interest rates, on a title insurer's prospective earnings and surplus growth. This integrated stress evaluation permits a more discerning view of a company's balance sheet strength relative to its operating risks.

While a company's BCAR is a useful indicator of its balance sheet strength, it is only one component of that analysis. Moreover, balance sheet strength is only one determinant of a company's overall FSR and ICR, which also depend upon its operating performance and business profile. BCAR is often a guideline to support a rating, but other factors driving expectations of future balance sheet strength influence the rating as well. All of these factors are significant to the overall rating process. Following is a description of the methodology used in the BCAR model.

Overview of BCAR

A.M. Best's capital formula uses a risk-based capital approach whereby net required capital is calculated to support two broad risk categories: underwriting risk and asset risk. A.M. Best's capital adequacy formula also contains an adjustment for covariance, reflecting the statistical independence of the individual components. A company's adjusted surplus is divided by its net required capital, after the covariance adjustment, to determine its BCAR.

Adjusted Surplus

A.M. Best makes a number of adjustments to a company's reported surplus within the Title BCAR model to provide a more economic and comparable basis for evaluating capital adequacy. These adjustments are related largely to the uniqueness of title insurance and its governing statutory regulations. Some of the significant positive adjustments to surplus include credits for statutory premium reserves in excess of IBNR; excess of replacement value over book for title plants (subject to a cap of 20% of surplus); and substantial credit for the nonadmitted portion of agents' balances. Additionally, adjustments to surplus are made for economic values embedded in loss and loss-adjustment expense reserves and fixed-income investments.

Significant negative adjustments also are applied to surplus, including economic stress tests that measure the potential impact of "economic shock" events. An example of such an event, as modeled in the stress tests, is a rapid increase in interest rates resulting in a slowdown in real estate activity. This type of event could have a significant impact on the demand for title insurance, and consequently could have a negative impact on future earnings and surplus growth.

Net Required Capital

Underwriting Risk

Underwriting risk is typically the largest risk category, encompassing the risks associated with net premiums written and net loss and loss-adjustment expense reserves. The net premiums written component is forward looking and requires capital based on the pricing risk inherent in a company's expected book of business for the upcoming year. The reserve component requires capital based on the risk inherent in a company's loss and loss-adjustment expense reserves, adjusted for A.M. Best's assessment of its reserve equity. In addition, required capital for the premium and reserve components may be increased to reflect an additional surcharge for "excessive" growth in exposure. Finally, although title insurance is a monoline business, credit is given for a geographically well-diversified book of business.

Asset Risk

Asset risk includes the following components: fixed-income securities, equities, interest rate, title plant impairment and credit risk. Capital charges are applied to different

BCAR Model — Structural Overview

BCAR Ratio = Adjusted Surplus/Net Required Capital

Adjusted Surplus	Net Required Capital
Reported Surplus	Asset Risk—
Plus:	Fixed-Income Securities Risk (B1) Equity-Market and Title Plant Impairment Risk (B2) Interest-Rate Risk (B3) Credit Risk (B4)
Surplus Adjustments—	Plus:
Statutory Premium Reserve Fixed-Income Equity Loss-Reserve Equity Title Plant (Adjustment for Fair Value) Agents' Balances Over 90 days	Underwriting Risk—
Minus:	Loss & LAE Reserve Risk (B5) Premium/Pricing Risk (B6)
Loss Scenario Adjustments—	Plus:
Standard BCAR: 250 BP Stress BCAR: 150 BP (Cumulative 400 BP)	Off-Balance Sheet/Business Risk (B7)
Minus:	Minus:
Other Adjustments (Debt, Intangible Assets)	Covariance Adjustment
Equals:	Equals:
Adjusted Surplus	Net Required Capital (NRC)

$$NRC = \sqrt{(B1)^2+(B2)^2+(.25xB3)^2+(.50xB4)^2+(B5)^2+[(.75xB3)+(.50xB4)+(B6)]^2} + (B7)$$

asset classes based on the risk of default, illiquidity and declines in market value of both equity and fixed-income securities. The BCAR model has incorporated an interest-rate risk component that considers the decline in market value of a company's fixed-income portfolio as a result of rising interest rates. Additionally, higher capital charges are ascribed to affiliated investment holdings; real estate and mortgages; below-investment-grade bonds; and nonaffiliated, privately traded common and preferred shares, because of the relatively illiquid nature of such assets as well as the potential volatility of their reported values.

For those companies that have a material amount of foreign investments in a particular investment category, the risk charge for that asset category may be increased to reflect the increase in volatility and/or decrease in liquidity associated with those foreign markets, financial systems and economies.

With regard to investments in affiliated title agencies, A.M. Best assigns a reduced asset-risk charge to ensure more consistent treatment between those entities that choose this type of organizational structure versus those with a branch structure. Also, A.M. Best assigns a capital charge reflecting the risk of impairment to the calculated fair replacement value of title plants, which are a title insurance company's core operating asset. The excess of replacement value over book also is credited to surplus on a tax-adjusted basis, subject to a cap.

Capital charges are applied to various receivable balances to reflect third-party default risk, including charges for premium receivables from agents and brokers. The title industry's unique business practices, which result in timing differences between when the real estate transaction closes and when premiums are reported, often result in significantly large nonadmitted agents' balances reflecting accounts receivable over 90 days. However, these balances typically have shown modest default risk. In recognition of this industry characteristic, the BCAR model gives substantial credit to surplus for the nonadmitted portion of premium balances and subjects both the admitted and nonadmitted components to the same asset-risk charge. However, any high concentration of nonadmitted receivables from any single entity/agent is subject to a higher risk charge. Finally, credit risk factors are applied to recoverables from all reinsurance companies.

Collectively, the underwriting and asset-risk components typically contribute almost all of the company's gross required capital. A third component, known as business risk, typically generates minimal capital requirements for off-balance-sheet items. Off-balance sheet items include items such as non-controlled assets, guarantees for affiliates, contingent liabilities, pension obligations and other post employment/retirement obligations.

Covariance Adjustment

A company's gross required capital, which is the sum of the capital required to support all of its risk components, reflects the amount of capital needed to support all of those risks if they were to develop simultaneously. However, these individual components are subjected to a covariance calculation within the BCAR formula to account for the assumed statistical independence of these components. The application of the covariance adjustment, which produces the company's net required capital, essentially makes the assumption that it is unlikely that all of the individual risk components will occur at the same time. Application of this covariance adjustment generally results in a moderate reduction in a company's gross required capital.

Formula Drivers

A majority of a company's gross capital requirement within A.M. Best's Title capital model is generated from its net premiums written and loss reserve components. Consequently, a company's BCAR value is influenced largely by the capital required to support its net underwriting commitment, which in turn is largely a function of its premium and reserve size; geographic diversification; mix of distribution channels; pace of premium growth; profitability; stability of loss development; and loss-reserve adequacy. The BCAR score of a company will be impacted negatively by higher capital requirements associated with higher underwriting leverage, greater indicated reserve deficiencies, and unstable or unprofitable business.

While the gross capital requirements generated from its investment risk, credit risk and interest-rate risk components are relatively low compared with premium and reserve risk, a company that maintains a more aggressive investment portfolio with relatively riskier and/or illiquid investments; is heavily dependent on pyramided capital; or has excessive credit risk likely will generate a lower BCAR value.

The basis of risk measurement for some of the key drivers of required capital in the title BCAR model is expected policyholder deficit. A.M. Best adopted the concept of Expected Policyholder Deficit to better calibrate the model's premium and loss-reserve risk factors, as well as other risk factors in the model. The Expected Policyholder Deficit concept allows risk charges to be calibrated to a specific level of insolvency risk and also takes into consideration the expected cost, or severity, of insolvency. The Expected Policyholder Deficit concept is reviewed in more detail in A.M. Best's methodology "Understanding BCAR for Property/Casualty Insurers."

BCAR Guidelines

Secure:

BCAR	Implied Balance Sheet Strength
175	A++
160	A+
145	A
130	A-
115	B++
100	B+

Vulnerable:

BCAR	Implied Balance Sheet Strength
90	B
80	B-
70	C++
60	C+
50	C
40	C-
<40	D

BCAR Is an Absolute Measure

BCAR provides an integrated evaluation of a company's underwriting and asset risk as it compares with the company's level of economic surplus. Within this evaluation, A.M. Best includes many adjustments that recognize company-specific risks to its adjusted surplus. Because of this integrated evaluation of operating risk, BCAR is an important tool in evaluating a company's balance sheet strength.

Since BCAR is the ratio of an insurer's own adjusted surplus to its own net required capital, BCAR is an absolute measure. A company's absolute capital adequacy ratio indicates whether its capital strength aligns with A.M. Best's "Secure" or "Vulnerable" rating categories and is based on the specific risk of a company's operation. In determining whether a company's capital strength is secure or vulnerable, a company's absolute BCAR is compared with the secure/vulnerable cutoff of 100%. An absolute ratio above 100% typically would be considered secure.

For a company with strong, stable operating performance, a strong business profile, high-quality capital and strong financial flexibility, the chart above provides a reasonable guide for the BCAR levels needed to support A.M. Best's financial strength rating:

Technical Review of the BCAR Formula

Below are summaries of key features and issues related to each of the distinct risk components of required capital, along with a discussion of adjustments made to reported

policyholder surplus within the BCAR model. The exhibit titled "Sample BCAR Score Calculation" illustrates the key aspects of the BCAR calculation for a hypothetical title insurer. It highlights the factors that drive its BCAR results and provides examples of company-specific adjustments.

Adjusted Surplus

A.M. Best makes a number of adjustments to a company's reported surplus within the capital model to provide a more economic and comparable basis for evaluating capital adequacy. These adjustments serve to even the playing field and to compensate for certain economic values not reflected in the statutory financials. They also take into account certain unique features of title insurance. Reported surplus is modified for equity adjustments related to statutory premium reserves, loss reserves, title plants, fixed-income assets on an after-tax basis and nonadmitted agents' balances on a pretax basis. Surplus also is adjusted for economic "shock events" such as a sudden increase in mortgage interest rates, which may have a negative impact on real estate prices and activity. Such events have a disproportionate impact on title insurers, whose operating revenue and earnings outlook are heavily influenced by fluctuations in demand for housing caused by volatility in real estate markets and general economic conditions. Events of differing magnitudes are used to arrive at "standard" and "stress" BCAR scores.

Excess Statutory Premium Reserves (SPR). While requirements vary by state, these reserves are mandated by most states to be carried on the balance sheet as a liability and are available for paying claims in addition to known claims reserves (KCR). However, because of state–mandated, formula-based reserving requirements that could be conservative in some instances, these statutory premium reserves may be in excess of net incurred but not reported (IBNR) loss reserves. In such cases, A.M. Best credits a company's reported surplus with the excess of SPR over that of IBNR reserves on an after-tax basis. In those cases where the SPR is below that of the IBNR reserves, the company posts supplemental reserves to bring the SPR up to the level of the net IBNR reserves, thus eliminating the shortfall.

Fixed-Income Assets. Surplus is adjusted to reflect an insurer's fixed-income securities' market value. This allows for a better view of a company's current economic capital position. The pretax benefit of this adjustment is limited to caps of +10% and -15% of surplus, and the result is then tax-effected.

Loss-Reserve Equity. A.M. Best adjusts surplus to reflect the net equity embedded within loss reserves. This equity represents the difference between a company's economic reserves, which reflect A.M. Best's view of ultimate reserves on a discounted basis, and carried reserves. The carried reserves equal the sum of the KCR and IBNR reserves. The adjustment enables A.M. Best to "level the playing field" and better differentiate companies that have historically under-reserved from those that have strong loss-reserve positions.

Title Plants. Title plants represent the core asset required for the ongoing operations of a title company. Due to their treatment in statutory accounting regulations, title plants must be carried on the balance sheet at original or acquired value, while maintenance and improvements cannot be capitalized and must be expensed. This leads to an understatement of the value of long-standing, established title plants. In recognition of the frequent understatement of the value of this asset on title companies' balance sheets, which in turn understates reported surplus, A.M. Best will estimate a current fair

replacement value of a company's title plant based on all information made available.

The initial estimate of fair replacement value may be based on the original or acquisition cost and any maintenance/improvements made on the plant over time, adjusted to current dollars using an inflation factor. Any additional information provided, such as an independent, third-party evaluation, may be used in determining a final estimate of the title plant's current fair replacement value. The excess of this replacement value over book may be credited to surplus on a tax-effected basis, subject to a cap of 20% of reported surplus.

Accounts Receivable Over 90 Days. Unique business practices within the title insurance industry often result in significantly large nonadmitted agents' balances, reflecting accounts receivable more than 90 days overdue. The over-90-day balance is primarily the result of the significant time lag between when the real estate transaction closes and when the policy is reported to the underwriter. Since the aging is based on policy effective date and not when it is received by the underwriter, the receivable frequently

Standard and Stress BCAR Score Calculation

Sample Title Company

($ Thousands)

ADJUSTED SURPLUS

	Baseline	35% Tax Rate	Tax-Adjusted Basis
Reported Surplus (Beginning)	$285,000	N/A	$285,000
Plus:			
Surplus Adjustments:			
SPR (excess over IBNR)	40,000	-$14,000	26,000
Fixed-Income Equity	3,000	-1,050	1,950
Loss-Reserve Equity	2,000	-700	1,300
Title Plants (Fair Value Over Book)	5,000	-1,750	3,250
Agents' Balances > 90 days	10,000	N/A	10,000
Total Surplus Adjustments	60,000	-21,000	42,500
Less:			
Loss Scenario Adjustments*:			
Standard BCAR: 250 BP 1-Year Impact to Surplus	-20,625	7,219	-13,406
Stress BCAR: 150 BP (Cumulative 400 BP) 2-Year Impact to Surplus	-94,465	33,063	-61,402
Equals:			
Adjusted Surplus (Standard)			314,094
Adjusted Surplus (Stressed)			266,098

* For a more detailed discussion, please see Appendix: Loss Scenario Testing and Impact on BCAR.

NET REQUIRED CAPITAL

Gross Required Capital

Equals:

Asset Risk	Baseline	Asset Risk Factor	Adjusted Req. Capital
Fixed-Income Securities	$215,000	0.030	$6,450
Equity Securities	95,000	0.150	14,250
Cash/Short-Term Investments	45,000	0.005	225
Title Plant	25,000	0.100	2,500
Credit Risk	30,000	0.050	1,500
Interest-Rate Risk	10,000	0.100	1,000
Total Asset Risk	420,000		25,925

Underwriting Risk	Baseline	Required Capital Factor	Adjusted Req. Capital
Loss and LAE Reserves	95,000	0.330	31,350
Net Premiums Written	1,450,000	0.140	203,000
Total Underwriting Risk	1,545,000		234,350
Off-Balance Sheet/Business Risk	1,000	0.010	10
Gross Required Capital	1,966,000		260,285
Less: Covariance Adjustment			-54,077
Equals: Net Required Capital			206,208

STANDARD BCAR =====>	**152.3**	**($314,094/$206,208)**
STRESS BCAR =====>	**129.0**	**($266,098/$206,208)**

is 90 days past due at the time the policy is reported to the underwriter. However, these balances historically have shown minimal default risk. In recognition of this industry characteristic, A.M. Best's capital model gives significant credit to surplus for the non-admitted portion of premium balances, subject to an evaluation of the agent concentration risk of such receivables.

Debt and Surplus Notes. A.M. Best's capital model emphasizes permanent capital and consequently will reduce a company's reported surplus for encumbered capital, which includes surplus notes and future debt-service requirements of an affiliated holding company. This reduction, in whole or in part, depends on an insurance group's magnitude of and dependence on debt-like instruments and their associated repayment features.

Both quantitative and qualitative factors are considered in the evaluation of debt. As part of the quantitative analysis, A.M. Best uses a separate model to assist in the determination of the amount of surplus credit given to surplus notes and debt instruments. The primary issue, which determines the level of credit given, is the term of the debt as compared with the length of time needed to pay the bulk of the policy liabilities. Usually, more credit is given to longer-term debt than to short term. Another key determinant is the company's rate of return compared with the interest rate charged on the debt. A company should be earning more than its cost of capital to receive credit for the debt.

On a qualitative basis, issues considered include where the debt is held vs. where the cash is used; the existence of other sources of income to offset the cost of debt; fixed-charge coverage; and the overall level of debt relative to the organization's total capital.

For example, when debt is issued at the holding company, but the cash is held at the operating insurance company, even though the cash is given full credit in the BCAR analysis of the operating company, the actual rating of the operating company could be limited by the evaluation of the financial leverage and earnings coverage at the holding company.

Economic Shock Loss and "Standard" BCAR. As title companies' profitability and operating revenues are tied closely to the magnitude and direction of interest rate changes, statistical relationships between these variables are used to measure the impact on a company's balance sheet from a 250 Basis Point (BP) increase in 30-year mortgage interest rates in one year. The impact on earnings then is deducted from current surplus on a tax-effected basis, and the resulting ratio of Adjusted Surplus divided by Net Required Capital is referred to as the "standard" BCAR.

Stress-Test Adjustments and "Stress" BCAR. A.M. Best's use of sensitivity analysis or stress testing within the framework of the BCAR model measures the ability of companies to withstand the impact from an economic "shock event" such as a sharp rise in mortgage interest rates. Therefore, A.M. Best also conducts a stress test of an additional increase of 150 BP in 30-year fixed mortgage interest rates for a cumulative two-year impact of a 400 BP increase. The resulting additional impact on a company's projected earnings in the second year then is deducted from the projected surplus on a tax-effected basis and the resulting ratio is known as a "stress" BCAR.

Depending on a company's ability to manage expenses during real estate down cycles, as well as its financial flexibility in terms of access to capital, the "Stress" BCAR could be as much as 30 points below the individual company's required Standard BCAR that supports its rating.

This multi-period approach is a useful indicator of both the strength of a company's current surplus position to absorb an immediate interest rate "shock event," as well as whether it has the financial resilience to survive a prolonged period of high interest rates. The loss-scenario tests use a statistical model of relationships between changes in interest rates and pretax operating margin to predict the impact on a company's earnings and consequently its surplus position.

(Please refer to the **Appendix** titled "Loss Scenario Testing and Impact on BCAR" for a more detailed review.)

Treatment of Key Risk Components of Required Capital

I. Underwriting Risk

To develop loss and loss-adjustment expense reserve risk factors, A.M. Best compared the carried calendar-year-end reserve with the projected ultimate development of those reserves for individual companies, using seven year-end evaluation points. The projected deviation from the original reserve provided an indication of the volatility of loss development. Similar calculations were made to measure the volatility in premium adequacy using a measure of operating profit, which was calculated by subtracting company expenses and ultimate losses from premiums plus investment income.

A. M. Best modifies both premium and reserve baseline capital factors based on a company's premium and reserve size. A.M. Best's analysis found greater variation in smaller companies than in larger companies for both premium and reserves. The variation of capital factors by size can represent a significant reduction to the industry baseline reserve risk and premium risk capital factors. This reduction reflects the inherent flexibility and diversification of a larger company to better monitor its reserves and pricing programs.

Loss and Loss-Adjustment Expense Reserve Risk

To a large extent, A.M. Best's loss and loss-adjustment expense reserve risk component emphasizes adjusted reserve leverage and stability in loss development as gauges of a company's exposure to reserving errors in its book of business. Consequently, all other factors being equal, the capital model will generate a greater reserve capital requirement for an insurer that is more leveraged or more volatile, after adjusting for A.M. Best's view of its reserve adequacy, than for its peer companies and vice versa.

Required capital for loss-reserve risk is generated by applying a capital factor to an insurer's adjusted loss reserves. To ensure equitable capital treatment among insurers, A.M. Best's model places considerable weight on a company's adjusted reserves, which emphasizes reserve adequacy and the time value of money imbedded in those reserves. An insurer that historically has under-reserved will be penalized for maintaining lower reported loss reserves. A.M. Best's reserve risk factor is based on an integration of the stability of a company's loss-development pattern, the size of the company's reserves and the inherent risk of title insurance. Consequently, a company's required capital for loss reserve is driven by these key factors:

Reserve Equity Adjustments. A company's carried loss reserves are adjusted to an economic basis that reflects A.M. Best's view of an insurer's ultimate reserves, which are discounted to their present value, recognizing the time value of money. Carried loss reserves represent the sum of the known claims reserves and the IBNR reserves, and they are adjusted to an economic basis through two company modification factors: the reserve deficiency factor and the discount factor.

The reserve deficiency factor reflects A.M. Best's view of an insurer's reserve deficiency expressed as a percentage of its original reserve plus 1. For example, a company with a 10% reserve deficiency would show a 1.10 reserve deficiency factor in the model, whereas a company with a 20% reserve deficiency would show a 1.20 reserve deficiency factor in the model. The initial determination of reserve deficiency is based on using a number of actuarial techniques within A.M. Best's loss-reserve model, including paid development, case-incurred development and expected loss methods. In addition to the reserve model, a diagnostic analysis of Schedule P and a qualitative assessment of the company's operating environment and historical reserve development are used to arrive at A.M. Best's view of reserve deficiency. Generally, unseasoned insurers with insufficient loss experience are compared with industry experience, while the reserves of seasoned insurers are determined relative to their own historical experience.

A number of issues can affect A.M. Best's view of a title insurance company's reserve position, including the number of reserve adjustments; the size of the adjustments; the policy years generating the adverse development; and whether the adjustment was anticipated or unexpected. For companies of concern, a minimum deficiency factor of 10% will be used in the model. A discount factor, based on the payout pattern of the individual company's reserves and a 4% discount rate, is applied to the estimated ultimate loss reserves. The resulting deficiency and discount factors are applied to a company's reported loss and loss-adjustment expense reserves to derive the company's adjusted reserves.

Reserve Capital Factors. Once adjusted reserves have been determined, they can be multiplied by company-specific reserve capital factors to determine a company's reserve capital requirement. The reserve capital factor is the capital charge associated with the risk of worse-than-anticipated development in a company's expected reserves. The company's reserve capital factor is determined by an industry baseline capital factor modified by the size of the company's reserves and the volatility of a company's case incurred loss development.

The industry baseline capital factor is a function of all individual companies' adverse/favorable loss-development data from seven prior year-end reserves that have had at least three years of observed development. The data then are used to analyze the potential variation in reserve deficiency for the industry as a whole, which determines the selection of an industry baseline capital factor. Depending on changes in loss-development patterns for the industry, this baseline capital factor may be updated annually.

"Stability factors" are used to differentiate the potential volatility in a specific company's loss reserves. The stability factors are calculated based on the stability of the company's case-incurred loss development pattern and could result in either an increase or a reduction in the baseline capital factor.

A. M. Best views the variation in a company's case-incurred loss development pattern as a strong indicator of the risk inherent in its loss reserves and of the company's ability to accurately project ultimate losses.

To calculate a company's final reserve capital factor, the stability factor is applied to the industry baseline capital factor, adjusted to reflect the size of the company's reserves. The final capital factor then is applied to the company's adjusted loss and loss-adjustment expense reserves to produce the required capital charge.

Growth Charge. A.M. Best also may apply a growth charge that reflects the additional risk that typically comes from rapid growth and is based on the growth in a company's exposures. The growth charge applied to the loss reserve aggregate required capital reflects the substantial risk a company faces in the claims and reserving areas during a time of significant growth. In applying a growth charge, A.M. Best also takes into account the unique nature of the title insurance industry, where the demand for its product is derived largely from changes in real estate market activity that often are subject to a high degree of volatility owing to rapid movements in interest rates and the housing market. A growth charge is applied when a company's growth in exposure exceeds industry thresholds, which vary over the real estate cycle. Therefore, A.M. Best takes into account the current phase of the real estate cycle in evaluating the growth in exposures for an individual company relative to the industry.

Net Premiums Written Risk

The required capital for premiums written within A.M. Best's capital model is generated by applying a premium capital factor to an insurer's written premiums. The premium risk capital factor is the capital charge associated with the risk that a company has underpriced its book of business. The charge is applied prospectively and is modified by the company's premium size and profitability.

To calculate the company premium capital factor, A.M. Best applies a company profitability factor to the industry baseline premium capital factor, adjusted to reflect the size of the company's net written premium. The capital factor then is applied to the company's written premium, net of any applicable reinsurance, to produce the required premium capital charge.

The industry baseline capital factor is developed from 10 years of policy year underwriting profit/loss data for individual companies as a ratio to premium plus other income. Credit is given in the profit/loss calculation to investment income earned on the loss and LAE payout pattern. These data then are used to analyze the potential variation in profitability for the industry as a whole, which determines the selection of an industry baseline capital factor. Depending on changes in industry profitability, this baseline capital factor may be updated on an annual basis.

The company profitability factor is used to modify the industry baseline capital factor and could result in either an increase or a reduction to the baseline capital factor. The measurement used to judge the profitability of an individual company is a five-year average ultimate policy-year underwriting profit and loss expressed as a ratio to premium plus other income.

A.M. Best believes the profitability of a company's business and the overall industry pricing levels are good indicators of the level of risk margin expected within a company's future business. Those companies with better historical profitability are expected to maintain a greater risk margin in the pricing and underwriting of future business and therefore require a lower premium capital factor.

Two final adjustments are made to the required premium capital charge. These adjustments include a charge to reflect the additional risk that typically comes from growth and the benefit derived from a more diversified book of business.

Growth Charge. This charge reflects the risks a company faces when generating substantial new business. The rapid growth can place increased pressure on its existing infrastructure, resulting in poor underwriting results due to weaker underwriting or poor claims handling. Calculation of the premium growth charge is identical to the

calculation of reserve growth charge and is applied directly to the aggregate required capital for premium risk. In the case of both the premium and reserve growth charges, adjustments are made to reflect issues within growth such as substantial historical control of the book of business.

Diversification Credit. For title companies, the diversification factor reflects the reduction in overall premium risk within a geographically well-diversified book of business, ranging from 1.00 (no diversification credit) to 0.70 (full credit). Although a significant share of title insurance premiums nationwide are written in the four large real estate markets of California, New York, Texas and Florida, those title insurance companies that have a more concentrated book of business are more susceptible to changes in regional real estate markets and economic conditions, and therefore face greater premium risk than companies that have a greater spread of risk.

II. Asset Risk

Investment Risk

Nonaffiliated Bonds. A.M. Best looks at the distribution of quality in an insurer's bond portfolio and assigns risk charges for default risk that are modestly higher than those applied by the National Association of Insurance Commissioners, with no capital charged for U.S. government bonds.

Common and Preferred Stocks. A.M. Best continues to apply its historical investment leverage approach, which assumes a 15% reduction in the market value of publicly traded common stocks held. A.M. Best continues to treat preferred stocks consistently with common stocks. However, for companies that have demonstrated their willingness and ability to hold onto preferred stock for the long term, the non-affiliated preferred stock portfolio will be treated in a manner similar to bonds and will receive risk factors based on NAIC designations provided in the annual statement.

Real Estate and Other Investments. Given the greater volatility of real estate investments and their risk of being valued improperly, A.M. Best applies higher risk factors to this asset class. Separate risk charges of 10% and 20% are applied to real estate occupied by the company and real estate held for investment purposes, respectively. In addition, A.M. Best applies a 20% baseline factor to Schedule BA assets, which typically include some speculative, higher-risk assets. These charges are broadly in line with the NAIC's risk factors.

Cash. The 0.3% risk charge applied to cash balances represents the risk that cash deposited in a banking institution may be uncollectible if the bank becomes insolvent. Short-term investments carry a 1% risk charge.

Title Agency Affiliates. A.M. Best recognizes that the affiliated status of such privately held entities, instead of being a branch in the organizational structure of a title insurance company, is largely a matter of form over substance. Therefore, such entities receive a lower investment-risk charge of 15% compared with other private investment affiliates, which will continue to receive a 100% risk charge. However, in the case of companies acquiring such entities, any goodwill resulting from such acquisitions will receive a 100% capital charge.

Title Insurer Affiliates. All investments in affiliated title insurers will be charged 100% to eliminate the stacking of capital, regardless of the investment schedule in which it is recorded (i.e., surplus notes recorded as other investments in Schedule BA, etc.).

Other Non-Insurance Investment Affiliates. A.M. Best charges the full statutory carrying value of the non-insurance affiliate to the parent. Unless a title insurer is actively committed to selling a non-insurer, with proceeds to be reinvested in the title insurance operations, A.M. Best's baseline treatment is a 100% capital charge. In this regard, A.M. Best presumes that the net asset value of the affiliate is needed to support its own operations and is not available to support the title insurance operation.

Title Plants. Title plants represent the core asset to the operation of any title insurance company. However, according to statutory regulations, they are carried on the books at original or acquired value, often resulting in a current fair replacement value in excess of book, especially in the case of long-standing title plants. Accordingly, if additional information is available and verifiable, A.M. Best may calculate a fair replacement value for such title plants and assign a risk charge to the entire value of 10%. The fair replacement value is capped at 20% of surplus.

Intercompany Loans. If an intercompany loan that normally is recorded as a liability is given surplus credit by A.M. Best, then the amount of credit given to the borrower will be removed directly from the surplus and the investments of the lender. The intent is to avoid giving surplus credit in more than one company.

Asset Concentration Adjustment. A.M. Best increases the asset risk charge for single, large investment holdings that are greater than 10% of surplus. This additional capital requirement applies to amounts in excess of the single investment limit, with the baseline charge for that investment type applying to the amount less than 10% of surplus.

Spread-of-Risk Factor Adjustment. A.M. Best's model generates additional required capital to support investment risk relating to the lack of portfolio diversification, utilizing a size factor related to the spread of risk among all major asset classifications. The factor decreases as the size of the invested asset base increases. This factor decreases from 1.5 (invested asset base of $5 million or less) to 1.0 (invested asset base of $500 million or more) and is applied to the total required capital for investment risk. The invested asset base excludes U.S. government bonds, affiliated investments and company-occupied real estate.

High Investment Leverage. Equity-market trends in the past several years have shown that companies with high investment leverage in common stocks generally are subject to greater volatility in their reported surplus. In response, A.M. Best will stress the capital with higher risk charges for those companies with high investment leverage in common stocks. The current baseline risk charge of 15% will be increased to 20% or 30% when common stocks are greater than 50% or 100% of reported surplus, respectively.

Credit Risk

Accounts Receivable Over 90 Days. As discussed earlier, the title insurance industry's unique business practices and statutory regulations often result in a significant accumulation of nonadmitted receivable agents' balances. However, these balances typically have shown modest default risk. Therefore, A.M. Best assigns the same risk charge of 5% to these balances as it does to receivables due less than 90 days, which are admitted under statutory accounting regulations. However, in instances where there is a high concentration of receivables from an entity/agent, the risk charge may be increased. A.M. Best also will give significant credit to surplus for the nonadmitted balances.

Other Receivables. Other receivable balances generally are assessed a 5% charge and represent a minor overall capital requirement.

Nonaffiliated Reinsurance. A.M. Best's capital model, which starts with a baseline 10% charge for nonaffiliated reinsurance recoverables, allows the analyst to assign risk charges based on a reinsurer's financial strength rating, which can range from a low of 2.0% for an A++ reinsurer up to a charge of 100% for companies with vulnerable ratings or unrated reinsurers will receive a 100% risk charge.

Affiliated Reinsurance. When analyzing an individual company's balance sheet strength, A.M. Best will charge for reinsurance due from both domestic and foreign affiliates. The charge will be adjusted based upon the financial strength rating of the affiliate using the same procedure that is used on nonaffiliated reinsurers. However, when analyzing a group's balance sheet strength, any intercompany reinsurance will be eliminated from the credit risk analysis.

Interest Rate Risk

Interest rate movements and their impact on real estate activity drive demand for title products and consequently have the greatest impact on a title insurance company's prospective revenue and earnings. However, when the insurer's prospective earnings are insufficient to absorb projected losses and expenses, as well as when an agency defalcation occurs, then that company also has a significant exposure to short-term cash needs and may be exposed to interest rate risk on its investment portfolio. To measure the risk of a decline in the market value of the fixed-income portfolio, A.M. Best uses an increase in interest rates of 250 basis points (BP) over a one-year period. The selection of a potential 250 BP increase in one year was based on a review of historical data over the past 30 years of the volatility and magnitude of actual interest rate increases, and is considered to be a scenario which is likely to result in a loss of earnings and surplus sufficient to force a premature liquidation of fixed-income securities.

The interest rate risk calculation takes into account the company's potential loss to earnings and surplus from the 250 BP interest rate increase. The potential loss represents the exposure of a company's invested asset portfolio to interest rate risk. The required capital for interest rate risk is calculated by taking the ratio of the company's potential loss to its liquid assets and then applying this factor to the company's decline in market value of fixed-income securities following a 250 BP rise in interest rates. However, since the increase of 250 BP is not expected to take place instantaneously, but rather over a period of one year, the company may be able to avoid premature liquidation of its fixed-income investments that have a short term to maturity (i.e., less than one year) and thus suffer no potential loss in their market value. Therefore, the required capital is discounted by a factor that takes into account bonds maturing in one year or less, reflecting the lower risk to capital from that portion of the portfolio.

By relating the company's potential loss to all liquid assets first, A.M. Best assumes a company is no more likely to liquidate a fixed-income asset at a loss than it is likely to liquidate any other investment at a loss. A.M. Best has established a minimum 10% potential loss exposure percentage applied against the company's decline in market value following the 250 BP rise in interest rates, recognizing that there may be other reasons for a company to have a short-term cash need, such as an agent's defalcation.

A.M. Best also will conduct additional "stress tests" on a company's balance sheet and earn-

ings. In such stress scenarios, the interest-rate test used is 400 BP over a two-year period. To measure interest rate risk for the purposes of the stress test, a minimum 15% potential loss exposure percentage is applied against the decline in market value from a 400 BP increase over two years. However, the required capital also is discounted by a slightly larger factor that takes into account bonds maturing in two years or less, reflecting the two-year time horizon over which the 400 BP increase in interest rates takes place.

Conclusion

BCAR is an important tool in the evaluation of capital adequacy. A.M. Best cautions, however, that although the BCAR model for title insurance companies is an important tool in the rating process, it isn't the sole basis of a rating assignment. BCAR, like other quantitative measures, has certain limitations and may not be the definitive measure of financial strength for every company in every situation. Consequently, capital adequacy should be viewed within the overall context of the operating and strategic issues surrounding a title insurance company. Business profile and operating performance are important rating considerations in evaluating a company's long-term financial strength and viability, as well as the quality of the capital that supports the BCAR result. In addition, any holding company considerations also will play a key role in evaluating the financial strength of a title insurance company.

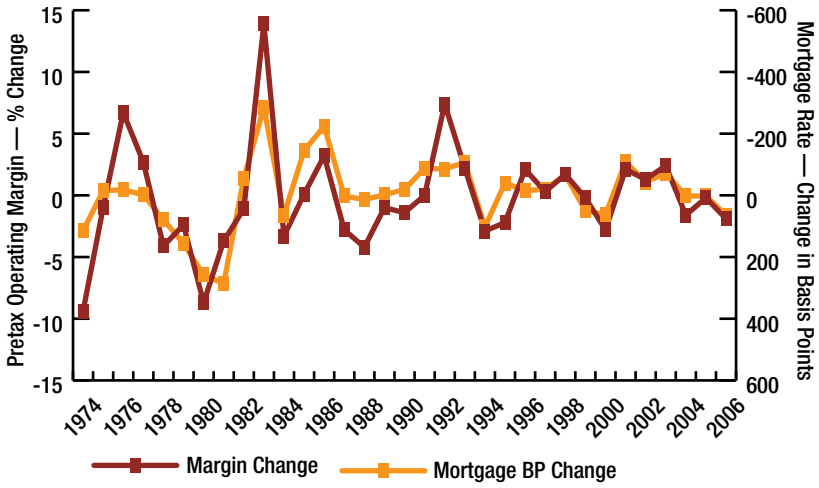
A.M. Best believes that well-managed and highly rated title insurers will continue to focus on the fundamentals of building future economic value and financial stability, rather than on managing the BCAR score, which is just one, albeit important, component of A.M. Best's rating evaluation.

Appendix: Loss Scenario Testing and Impact on BCAR

Title insurance is unique among most insurance lines in that the demand for its product is derived largely from a single industry, i.e., real estate. Since a residential or commercial title policy is either sold or renewed only when a home or business is either purchased or the mortgage on that asset is refinanced, title industry revenues and earnings are largely a function of the level and trend of activity in real estate markets. Real estate market activity, in turn, is partly determined by interest-rate movements. Generally, a rapid rise in mortgage interest rates results in reduced transactions in real estate markets and consequently a decline in demand for title insurance.

Business Cycle Trends

Pretax Operating Margin vs. Mortgage Rates (Annual Changes)
Note: Scale on Change in Mortgage Rate Inverted to Show Relationship



The objective of A.M. Best's loss scenario tests for title insurance companies is to measure their ability to withstand the impact of economic "shock" events, such as a significant increase

in mortgage interest rates, that negatively impact their capital position. Since a title company's profitability and operating revenue normally are closely tied to the direction of interest-rate changes, the tests use statistical relationships between these variables to measure the impact on individual companies' balance sheets.

The loss scenario tests typically are structured to capture the impact from two successive interest-rate events: a 250 Basis Point (BP) rise in interest rates in the first year, followed by a 150 BP rise in rates in the second year, for a cumulative impact of 400 BP over two years. Although both tests are designed to stress the capital position of an individual company, the 250 BP test is included as part of a "Standard BCAR."The second-year test of an additional increase of 150 BP thus is considered to yield a "Stress BCAR."The choice of using the first-year 250 BP and second-year 150 BP scenarios was based on data of actual interest-rate movements over the past 30 years.

Loss Scenario Tests: Numerical Example

($ Millions)

Sample Title Company		
Prior Year Operating Revenue	$2,000.0	
Prior Year Pretax Operating Income (PTOI)	$100.0	
Prior Year Pretax Operating Margin	5.00%	
Standard BCAR Test: (250 Basis Point Increase)		
Prior Year-End/Current Year Beginning Surplus	**$285.0**	
Current Year Operating Revenue	$1,650.0	A
Change in Pretax Operating Margin	-6.25%	B
Current Year Pretax Operating Margin (After Impact)	-1.25%	(5.00% - 6.25%)
Current Year PTOI (Pretax Margin * CY Op. Rev.)	$(20.6)	(-1.25% * 1,650)
Tax Rate	35%	
Tax-Effected Impact to Current Year Surplus	**$(13.4)**	**(adjust surplus if < 0)**
Current Year-End Surplus Position	**$271.6**	**(285.0-13.4}**
Current Year Operating Revenue	$1,650.0	
Current Year Pre-Tax Operating Income	$(20.6)	
Current Year Pre-Tax Operating Margin	-1.25%	
Stress BCAR Test: (150 BP Increase—Cumulative 400 BP)		
Current Year End/Subsequent Yr. Beginning Surplus	**$271.6**	
Subsequent Year Operating Revenue (impacted by 150 BP)	$1,476.8	C
Change in Pretax Operating Margin	-3.75%	D
Subsequent Year Pretax Operating margin (after impact)	-5.00%	(-1.25% - 3.75%)
Subsequent Year PTOI (Pretax Margin * SY Op. Rev.)	$(73.8)	(-5.00% * 1,476.8)
Tax Rate	35%	
Tax-Effected Impact to Subsequent Yr. Surplus	**$(48.0)**	
Subsequent Year-End Surplus Position	**$223.6**	**(271.6-48.0)**
Total 2-year impact to Surplus from Stress Test	**$(61.4)**	**(Adjust surplus if < 0)**

Footnotes:

Modeled Profitability/Interest Rate Relationship reflected above:	Modeled Revenue/Interest Rate Relationship reflected above:
Basic Relationship:	Basic Relationship:
Chg in 100 BP Chg = Chg in Pretax Operating Income of 2.5%	Chg in 100 BP = Chg in Pretax Operating Revenue of 7%
B 250 BP increase = (250/100 = 2.5 × -2.5% = -6.25% decrease in PTOI)	A 250 BP increase = (250/100 = 2.5 × -7% = -17.5% decrease in PTOR)
D 150 BP increase = (150/100 = 1.5 × -2.5% = -3.75% decrease in PTOI)	C 150 BP increase = (250/100 = 1.5 × -7% = -10.5% decrease in PTOR)

Note:
Interest rate data used in model reflect the annual average yield of the 30-year fixed mortgage interest rate as published by the Federal Reserve.

The loss scenario tests use a basic statistical relationship between changes in interest rates and pretax operating income (underwriting results including escrow and other title fees and services) to determine the impact on a company's earnings and surplus.The basic relationship, which was based on statistical modeling and econometric analysis of interest rate and earnings data for the industry, found that for every 100 BP increase in interest rates, the pretax operating margin was reduced by 2.5 points. (Note: for interest rates, the data used was the 30-year fixed mortgage rate, while pretax operating margin is defined as pretax operating income (PTOI) divided by pretax operating revenue).

This basic relationship then is used to calculate the first-year (250 BP increase) and second-year (150 BP increase) impact on a company's pretax operating income and surplus. For example, a 250 BP increase in interest rates represents a reduction in pretax operating margin of 6.25% (250 BP increase = (250/100) × 2.5% change in PTOI = 6.25% reduction in pretax operating margin).

During periods of strong real estate market activity when title insurance companies are generally profitable, the impact of a 250 BP increase may not result in a loss of surplus, depending on the company's initial margin of profitability (i.e., before the 250 BP impact). However, during downturns in the real estate market when profit margins are weak or negative, the impact of a 250 BP increase in interest rates is likely to be negative, resulting in a loss of surplus. In such cases, any resulting pretax operating loss is deducted from beginning surplus on a tax-effected basis, and this projected lower surplus number at the end of the first year then becomes the starting point for the impact of the second-year, additional 150 BP increase.The resulting impact on earnings from the second-year, 150 BP test then is deducted from the projected surplus on a tax-effected basis.Therefore, the surplus at the end of the two-year period represents the total cumulative impact on a company's capital position of a 400 BP increase over two years.

A.M. Best also recognizes that as interest rates rise, operating revenue tends to decline. Therefore, based on statistical modeling of historical industry revenue and interest-rate data, the model assumes that for every 100 BP increase in interest rates, operating revenue declines by 7%. For example, a 250 BP increase in interest rates represents a reduction in operating revenue of 17.5% (250 BP increase = (250/100) × 7% change in pretax operating revenue = 17.5% reduction).

From a rating perspective, depending on an individual company's access to capital and financial flexibility, along with its ability to manage expenses over the course of a real estate down cycle, the "Stress" BCAR could be as much as 30 points lower than the company's required BCAR needed to maintain its current rating level.

A.M. Best would like to caution that interst rates are only one of a number of economic variables that may impact a title insurer's operating results and future financial strength. Therefore, either the magnitude of the interest-rate increase or the type of economic variable used for the above tests may change in the future, depending on prevailing market circumstances. In addition, the application of the stress test can vary over the real estate cycle. During the down side of the cycle, the stress test may be used as a directional measure of the rating in the form of a rating outlook. Since this test looks out into the future two years, companies have ample time to take corrective actions such as reducing expenses to mitigate operating losses during this difficult period.The rating outlook therefore would be based not only on the stress test, but also on discussions with management to determine what, if any, mitigating actions they are taking and how well they historically have navigated through previous down cycles in the real estate and financial markets.

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