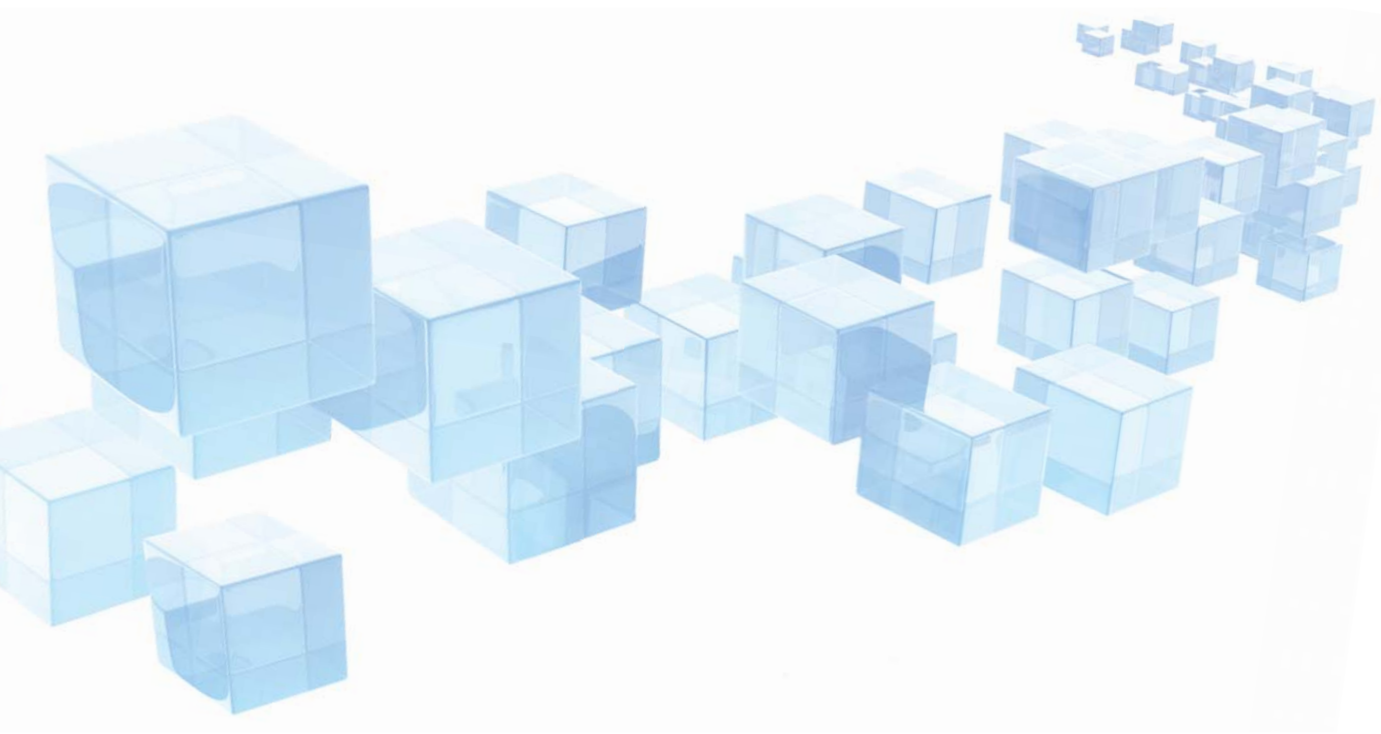
BEST'S METHODOLOGY AND CRITERIA

Rating Run-Off Insurers & Specialists

October 13, 2017



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Outline

- **A. Market Overview**
- **B. Rating Considerations: Run-Off Insurers**
- **C. Rating Considerations: Run-Off Specialists**

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

A. Market Overview

Although run-off insurance companies are evaluated similarly to other insurers, they possess unique characteristics that require additional analysis during the rating process. This criteria procedure describes 1) the approach to rating insurance companies that have been placed into run-off—run-off insurers; and 2) the approach to rating run-off specialists—insurance companies that acquire and manage runoff (re)insurers or run-off books of business.

A.M Best's Rating Process

Exhibit A.1 outlines A.M. Best's rating process.

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

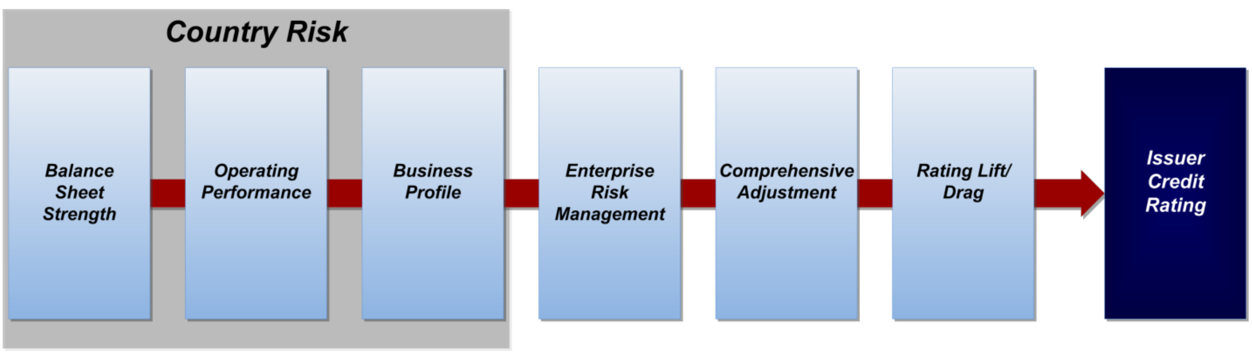

Exhibit A.2 details the assessment descriptions for balance sheet strength, operating performance, business profile, and enterprise risk management.

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Exhibit A.2: BCRM Assessment Descriptors

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

The following sections discuss the particular features of run-off insurers and run-off specialists that may affect their evaluation differently from the general approach outlined in the BCRM.

B. Rating Considerations: Run-Off Insurers

Balance Sheet Strength

A.M. Best's assessment of the strength and quality of a company's balance sheet is the foundation of its credit ratings. For an insurer in run-off, balance sheet strength is the most important factor to evaluate when determining claims-paying ability. A.M. Best also evaluates a run-off company's asset allocation strategy for risk and sustainability. Future investment income projections are evaluated against prior portfolio yields and new money rates.

The balance sheet strength assessment of a property/casualty run-off company generally focuses on (1) the adequacy of loss reserves to meet a company's policyholder obligations; (2) the credit risk and structure of any existing reinsurance program; and (3) the liquidity profile, asset allocation, and revenue generated by the company's investments. For life/annuity insurers in run-off, similar areas are reviewed; however, the nature of a life/annuity insurer's liabilities often makes the run-off period significantly longer than that of property/casualty and some health insurance businesses.

For property/casualty insurers, estimating the timing and amount of future loss reserve payout patterns on a run-off portfolio is subject to considerable uncertainty, especially when policy limits are high and claim settlements are unpredictable. Credible estimates of future payout patterns are critical to the forward-looking evaluation of a run-off insurer's creditworthiness and are a key component of A.M. Best's balance sheet analysis. Special attention is paid to the historical payout patterns of the blocks of business: The risk of adverse reserve development could threaten the capitalization of a run-off company even more than that of a typical property/casualty (re)insurer, given the absence of annual renewal premium income to offset cash outflows that may have unexpected size or timing. The reasons for placing the company into run-off are considered when determining what adjustments to make to the company's BCAR (Best's Capital Adequacy Ratio), to appropriately reflect the change in the company's circumstances.

Many run-off life/health companies may have significant streams of renewal premiums, particularly for life insurance products, which give them the option to fund claims/benefits with either new money or existing investments. As a result, liquidity risk often is seldom materially higher for these insurers than it is for companies not in run-off, and the ability to change asset allocation does not diminish significantly. U.S.-style annuity blocks in run-off face liquidity risks from increased surrenders owing to low crediting rates or distributors' behavior. The ability of run-off companies with no new premium to invest to cost-effectively change their investment allocation is limited.

An insurer's balance sheet strength assessment may not necessarily change immediately when a company is placed into run-off, depending on the evaluation of the factors outlined above and on whether the insurer can maintain its surplus at pre-run off levels while supporting the remaining balance sheet risks. However, given heightened uncertainty about the future condition of the insurer's balance sheet, a balance sheet strength assessment of "Strongest" is highly unlikely to be maintained. Management often looks to optimize a rating unit's capital and deploy that capital in the most efficient way throughout the organization, which could weaken the run-off company's balance sheet strength. The assessment could be even lower if the run-off status calls into question the insurer's ability to meet its policyholder obligations, particularly when those obligations are long-dated.

Operating Performance

A.M. Best views operating performance as a leading indicator of future balance sheet strength and long-term financial stability. A rating unit's profitability affects its ability to generate earnings—weak earnings will not allow a company to effectively execute its strategy.

Many life/annuity run-off companies are quite profitable, given the absence of new business expense strain. These companies often grow their surplus organically, sometimes more quickly than companies writing new business. In contrast, other run-off insurers may be subject to increased levels of volatility.

More stable and profitable run-off insurers may be eligible for an "Adequate" assessment, while others—depending on their volatility—may receive a lower assessment.

Business Profile

A.M. Best looks at a company's business plan when assessing its business profile. Given its run-off status, a run-off insurer would not typically be eligible for an assessment higher than "Limited" because the level of diversification and differentiation will erode over time. In addition, distribution relationships are likely to have been terminated and brand awareness is no longer a focus.

Enterprise Risk Management (ERM)

The circumstances surrounding the decision to place an insurer into run-off may result in an ERM assessment of "Weak" or even "Very Weak." If A.M. Best believes that prospectively the insurer has an appropriate framework in place to manage its risks, an assessment of "Appropriate" may be possible.

Rating Lift/Drag

A run-off insurer is highly unlikely to be a lead rating unit, but it may be eligible for rating lift or drag due to its affiliation with a larger organization (the lead rating unit).

The approach for applying rating lift/drag for a run-off company that is part of a larger group is similar to the approach for applying rating lift/drag to other insurers, which includes an analysis of the likelihood and level of future financial support from the group based on the run-off company's strategic importance to the enterprise. Since a run-off company that is part of an enterprise focused on ongoing operations is less likely to be considered strategically important to the overall operation, the decision to afford rating lift/drag will be based primarily on the degree to which its operations cannot easily be separated from those of the parent or affiliates.

An exception to this is a run-off entity owned by a parent that is a run-off specialist or that maintains a dedicated run-off business segment. In this instance, the run-off entity is more likely to be considered strategically important, given the run-off specialist's focus on acquiring and profitably managing the settlement of reserve liabilities.

C. Rating Considerations: Run-Off Specialists

Run-off specialists are (re)insurance companies that acquire reserve liabilities to profitably manage the settlement and payout of claims until all of the liabilities are exhausted. A run-off specialist uses its experience managing complex claims, its specialized focus, and its economies of scale to profitably manage the run-off of loss reserves and is motivated to effectively run off acquired entities, thereby easing future regulatory approval of additional acquisitions.

A seller may want to dispose of a portfolio of reserves to achieve a clean exit from the business, lower administrative costs, focus on growth opportunities, or reduce the risk of adverse reserve development. Run-off specialists can acquire reserve liabilities in a number of ways, including a loss portfolio transfer, quota-share agreement, or the purchase of an entire company. Notwithstanding the form, the run-off specialist receives assets as consideration for assuming contractual liability for the payment of losses associated with the reserves.

The rating process for run-off specialists generally follows the process outlined in the BCRM. The approach used to analyze the liabilities and assets of insurers in run-off applies to run-off specialists. Additional considerations that may be particular to a run-off specialist based on its unique business strategy are discussed in the following sections.

Balance Sheet Strength

For each potential acquisition of material size, A.M. Best re-evaluates a run-off specialist's current and prospective capitalization. The analysis of financial projections for operating performance and capitalization is guided by the principle that growth will be driven by acquisitions whose size, number, and profitability are uncertain and could vary widely. The uncertainty inherent in these factors affects the amount of capital required. While capital at an entity owned by a run-off specialist may experience less pressure to be reallocated to other areas than within an active insurance group, the ability of a run-off specialist enterprise to support all of its run-off liabilities is finite. Thus, the run-off specialist's ability to support older acquisitions is reconsidered each time new run-off reserves are acquired. In addition to performing an analysis of the historical claim settlement history of a block of business targeted for acquisition, the discount rate, expenses, and profit margin assumptions used in pricing the deal are reviewed.

One distinguishing characteristic of a run-off specialist is that it acquires all of its reserves from motivated sellers, which raises the risk of adverse selection. As a result, when analyzing a run-off specialist, examining the stringency of the due diligence process when acquiring new blocks of business is critical. A.M. Best may request actuarial reports detailing the past performance of current and prospective blocks of business. In addition, A.M. Best reviews the level of conservatism built into projections of future claims and benefit payments, in light of the uncertainty of profitability due to the risks of mispricing and adverse selection.

Operating Performance

Insurers may rid themselves of legacy or non-core blocks of business to better meet return targets and/or free up trapped capital; depending on its capabilities, a run-off specialist may be able to take advantage of these divestitures. A well-directed run-off specialist managing a run-off insurer may handle claims more efficiently and have lower administrative costs, improved standards of service/technology, and experienced management given its specialization, resulting in lower overall expense ratios. However, in the initial stages of building up a book of business, run-off specialists may lack the scale to achieve these goals. Moreover, reinsurance dispute risk can be greater if placing an entity in an active insurance group into run-off results in an abrupt end to the business relationship and associated premium with the reinsurer.

Depending on the run-off specialist's acquisition strategy, its top-line growth may be assessed differently from a conventional insurer's. Less weight may be placed on the run-off specialist's year over year growth in premium; because of the block acquisition business model of the run-off specialist—benchmarking against the industry's growth in premium may not be appropriate. Instead, the strength of their negotiating position, reputation, and ability to acquire good quality books of business, as demonstrated through its operating performance, is considered.

When reviewing an acquisition, A.M. Best examines a run-off specialist's track record of improving operating results, which may result in a better—or worse—view of the acquired company or block's operating performance.

Business Profile

Experience in managing run-off companies/blocks is a key part of the business profile evaluation. A run-off specialist's financial projections may have more credibility if management has a successful track record of executing its run-off strategy. The experience of management's prior deals is even more important in evaluating a run-off specialist. A.M. Best incorporates any prior acquisitions with a history of unanticipated, material adverse development into its view of management's profitability projections.

Run-off specialists often focus on certain product lines while avoiding others. A.M. Best reviews a run-off specialist's strategy for product risk as well as for any geographic/product concentration. Pricing sophistication and data quality are also emphasized, while market position and distribution channels are of lower importance. Note: Some run-off specialists do maintain distribution relationships for acquired companies/blocks.

Enterprise Risk Management

The review of a run-off specialist's ERM is generally similar to that of other insurers. However, a run-off insurer owned by a run-off specialist with sophisticated technology and proven operations in place- may be exposed to less operational risk than one owned by a traditional insurance group.

Rating Lift/Drag

The approach for applying a rating lift/drag to a run-off specialist that is part of a larger group is similar to that used for applying rating lift/drag to other insurers.

Published by A.M. Best Rating Services, Inc.

METHODOLOGY

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Version 020116