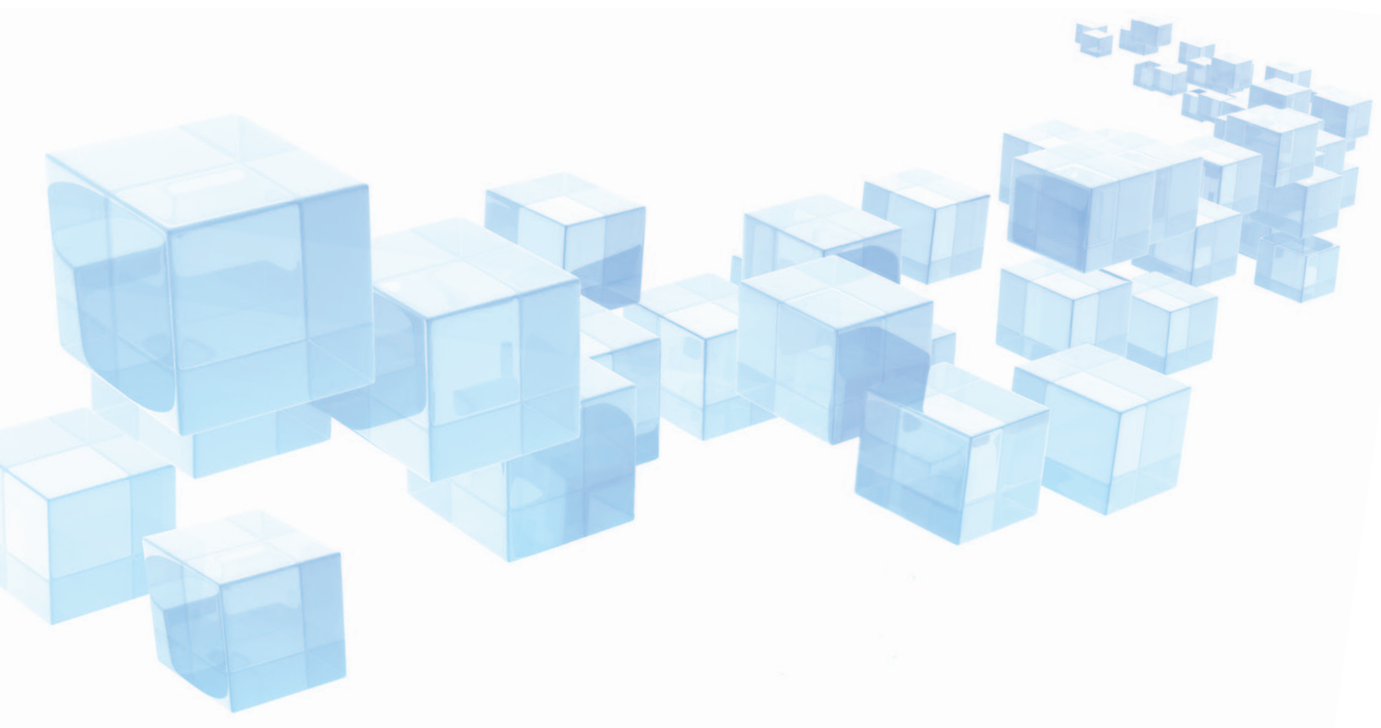
BEST'S METHODOLOGY AND CRITERIA

Analyzing Perpetual Insurers

October 13, 2017



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Outline

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 AM Best's rating process.

A. Market Overview

Traditional Perpetual Insurers

Perpetual insurance is the oldest form of property insurance offered in the United States, with the first policy offered in the 1750s. A perpetual policy is unique because it is underwritten without a termination date. Rather than paying an annual premium, the policyholder generally makes a fully refundable deposit to the company for insurance coverage. The company then invests those funds in securities that provide the primary source of revenue to cover future losses and expenses. The amount of the perpetual deposit calculated by the insurer is typically a significant multiple of an average one-year term insurance policy for the same risk. If the insured cancels the policy at any time, the entire deposit is refunded, regardless of claims activity, without interest. Because of the fully refundable feature of the deposit, it is recorded as a liability on the company's balance sheet and not as premium revenue.

Another distinguishing feature of perpetual insurers is that they tend to follow a long-term buy-and-hold investment strategy. Their equity investment allocations are frequently a substantial component of their surplus base, typically consisting of long-held, blue-chip issues with a significant amount of embedded unrealized capital gains.

Assessable Mutuals

A perpetual insurer may also take the form of an assessable mutual, in which the policyholder pays an initial premium that may be higher than that of a term policy, but considerably lower than a perpetual deposit. This is followed by annual assessments, typically expressed as a percentage of the initial premium, which are dependent upon the insurer's past, present, and projected operating results. The initial premium and subsequent annual assessments are fully earned in the year billed. Typically, insurers must meet certain regulatory guidelines to qualify as an assessable mutual.

The Rating Process

AM Best's rating process (**Exhibit A.1**) entails an assessment of an insurer's balance sheet strength, operating performance, business profile, and enterprise risk management. The assessment of these building blocks includes adjustments designed to account for a perpetual insurer's unique policy structure. For example, depending upon its structure, the business profile assessment of a perpetual insurer may be "Limited" (**Exhibit A.2**).

Exhibit A.1: AM Best's Rating Process

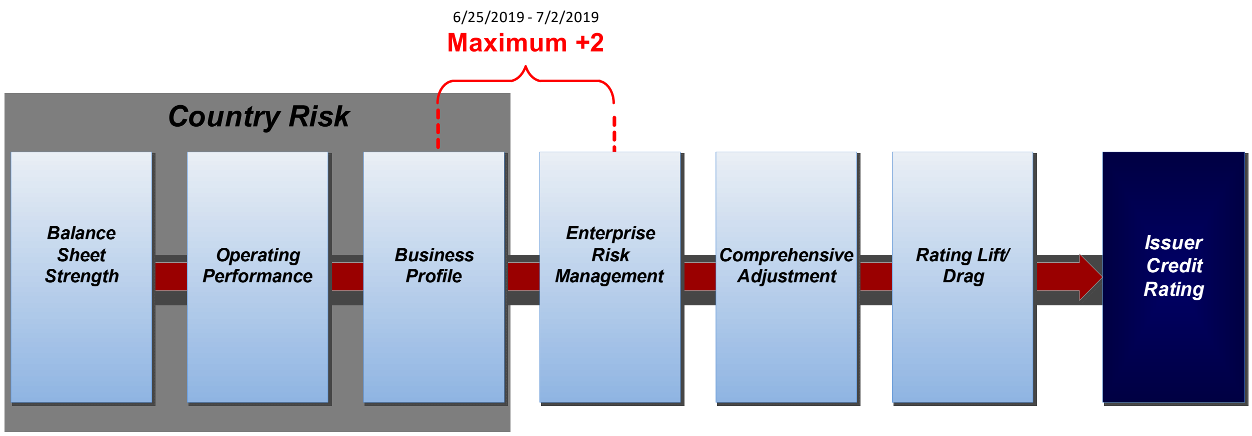

Exhibit A.2: BCRM Building Block Assessments

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		

B. Balance Sheet Strength

Given that the asset allocation of perpetual insurers favors long-term investments, investment reports and guidelines help reveal potential concerns, such as sector concentrations, large single-issue investments, and the degree of volatility in returns. The analyst also reviews how investments are managed, be it internally or externally and at how the investment manager's performance is evaluated.

BCAR Adjustments

For perpetual insurers, the adjustments made to the balance sheet strength assessment center around the calculation of Best's Capital Adequacy Ratio (BCAR). The lack of traditional reported net written premium means that the BCAR model needs to be adjusted to fully capture the pricing risk represented by the accumulated deposits or assessments.

Consistent with the perpetual insurer's income statement, the premium amounts shown in BCAR are typically negative, reflecting ceded premium for any reinsurance treaties the insurer may have. Thus, the underwriting exposure represented by the deposits needs to be converted into a term-equivalent premium base, which then can be risk-charged by the capital factors in BCAR, to generate an appropriate premium risk charge.

There are two ways to convert the underwriting exposure to an annual term-equivalent premium:

1. The analyst calculates a term-equivalent premium based on the comparable average premium for a typical term policy and applies it to the existing policies in force.
2. The company provides an estimate of its net written premium (usually based on the subject premium of its existing reinsurance contracts, which can be used as a proxy for its term- equivalent premium).

The analyst uses the output from whichever method is used to calculate the appropriate pricing risk charge in the BCAR model. Converting the perpetual deposits into a term-equivalent premium results in a more accurate capture of pricing risk exposure in BCAR.

Because of the critical role of total investment returns and the challenges associated with accurately projecting them over the extended life of the company's policies, a perpetual insurer's net required capital levels typically will need to be more conservative, particularly for those using the perpetual deposit method.

Exhibit B.1: Example of a Term-Equivalent Premium Adjustment

Before Adjustment
Baseline Net Written Premium: -$1.5M

Baseline premium in BCAR is typically negative for perpetual insurers as they book only ceded premium. The baseline premium thus needs to be adjusted to reflect term-equivalent premium. In this example, the baseline net written premium in BCAR is -$1.5 million, which represents the ceded written premium.

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After Adjustment
Term-Equivalent (TE) Net Written Premium: $4.5M

- Average Deposit on a Typical Perpetual Policy
  $12,000
- Average Premium of Comparable 12-month TE Policy
  $1,500
- Total Policies in Force
  4,000
- TE Direct Written Premiums
  $6 million = $1,500/policy × 4,000
- TE Net Written Premiums
  $4.5 million = $6 million DWP - $1.5 million ceded

C. Operating Performance

Because of a perpetual insurer's unique business model, which does not report traditional written or earned premium, many of the standard underwriting and operating performance metrics used to evaluate a property/casualty term insurer are not applicable. Since the perpetual deposit is fully refundable, the perpetual insurer does not record it as premium revenue. Thus, certain underwriting ratios—the loss and loss-adjustment expense (LAE) ratio, expense ratio, combined ratio and investment income ratio, all of which are calculated by using written or earned premium as the denominator—are not meaningful. This also renders operating return measures such as pre-tax and after-tax return on revenues as not-applicable, given that premium revenues are not a significant part of a perpetual insurer's income statement.

For the analyst, return measures such as TROIA (the total return on invested assets, a measure of the investment portfolio's profitability) and total ROE (return on equity, which takes into account both investment and underwriting performance) are better indicators of a perpetual insurer's overall profitability. Loss data are requested from management to show the profitability of the book of business. In addition, expense data are evaluated to measure the operation's efficiency. As in the analysis of traditional homeowners writers, trends in these measures, typically over the past five years, are evaluated. An important difference between deposit-based perpetuals and the assessable mutuals, however, is that assessable mutuals are able to increase their annual assessment rates when operating or investment results are affected negatively by catastrophe losses or volatile investment markets.

The evaluation of a perpetual's long-term profitability and capital generation considers management's assumptions regarding total investment returns. Fluctuating interest rates and volatile equity markets present challenges regarding expectations of future investment income and capital appreciation. However, a complete understanding of these assumptions—which are integral to arriving at the amount of perpetual deposit sufficient to support the long-term nature of the company's underwriting risk—is a key component of the analytical process.

For deposit-based perpetuals, there is an inverse relationship between new business growth or retention and interest rates. If interest rates are high, existing perpetual policyholders may opt to surrender their policies to get full deposit refunds, or potential insureds might not purchase perpetual policies, as returns on market-based investments may be more attractive. Because the deposits are recorded as liabilities, the surrender of an existing policy would not reduce surplus. Conversely, if market interest rates are low, current and potential insureds may view a perpetual policy more desirable. Policy language is evaluated to determine whether there are any long-term concerns regarding emerging risks to which the company cannot typically respond because of the policy's permanent nature.

Since the perpetual business model is so dependent on investment returns, capital gains/losses both before and after taxes are evaluated. The rating process also takes into account earnings volatility driven by both investments and underwriting, and its resulting impact on surplus.

D. Business Profile

A deposit-based perpetual insurer is highly unlikely to receive a business profile assessment higher than "Neutral." The large deposit required to purchase a perpetual insurance policy serves as a high barrier to entry for other insurers interested in serving a more diversified insured base; however, that barrier also serves as a constraint on the deposit-based perpetual's business profile assessment. The deposit-based perpetual's customer base is generally limited to more affluent individuals or households. Thus, although the degree of competition a perpetual insurer faces may be low, its overall market position and product/geographic concentration may outweigh this benefit.

Conversely, assessable mutuals may not be subject to the same business profile limitations because they are able serve a more diverse population given that their initial premiums are in many instances within current market pricing.

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