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Best's
Methodology and Criteria

Best's Credit Rating Methodology

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Part I: Introduction

Outline

A. Purpose of Document
B. Best's Rating Process
C. Assumptions
D. Best's Credit Rating Approach

A. Purpose of Document

Best's Credit Rating Methodology (BCRM) provides a comprehensive explanation of AM Best Rating Services' (AM Best) rating process. Best's Credit Ratings (BCR) include Best's Financial Strength Ratings (FSR), Best's Issuer Credit Ratings (ICR), Best's Issue Credit Ratings (IR) and Best's National Scale Ratings.

The process for determining a BCR includes an in-depth evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management, as described in **Part III: The Rating Process**.

Given AM Best's extensive knowledge of the insurance industry, an array of both quantitative and qualitative measures is used to analyze rated organizations. The examples cited throughout BCRM are not intended to be a comprehensive or exhaustive list of all financial metrics and qualitative factors considered in the analytical process.

B. Best's Rating Process

The foundation of AM Best's credit rating process is an ongoing dialogue with the rated company's management, which is facilitated by a rating analyst. Each interactively rated entity is assigned to a rating analyst. The rating analyst manages the ongoing interaction with company management and conducts the fundamental credit analysis described in AM Best's rating criteria. The rating analyst monitors the financial and non-financial results and significant developments for each rated entity or issue in their portfolio. While ratings are generally updated on an annual basis, a rating review can take place any time AM Best becomes aware of a significant development that may have an impact on the rating.

The ongoing monitoring and dialogue with management occurs through scheduled rating meetings, as well as interim discussions on key trends and emerging issues as needed. These meetings afford the

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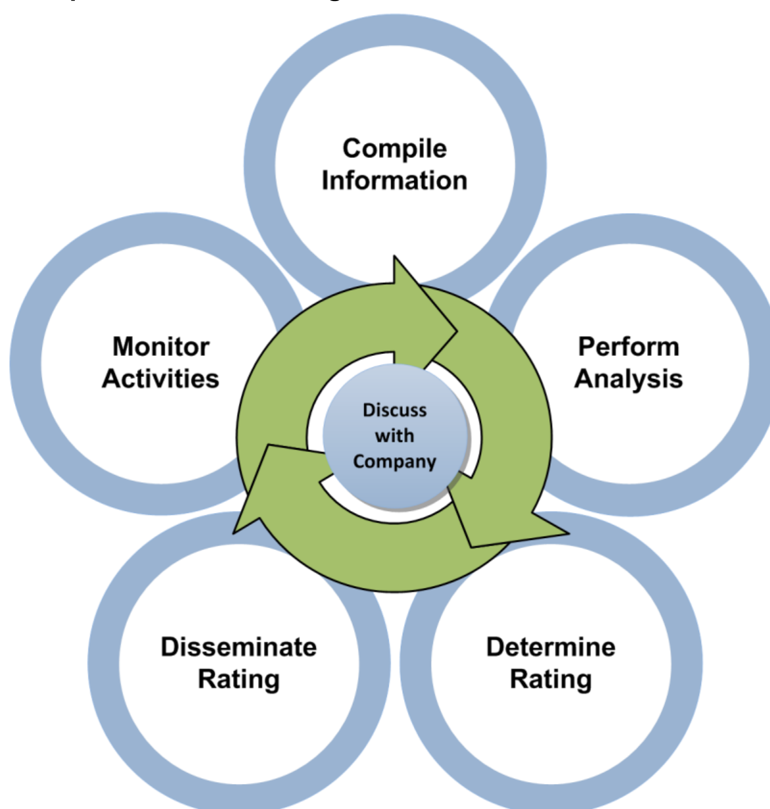
rating analyst the opportunity to review factors that may affect the company's rating(s), including its strategic goals, financial objectives, and management practices.

BCRs are initially determined and periodically updated through a defined rating committee process. The rating committee itself consists of analytical staff and is chaired by senior rating officers. The committee approach ensures rating consistency across different business segments and maintains the integrity of the rating process. The rating process consists of the following broad components pictured below:

Exhibit B.1: Broad Components of the Rating Process



Compile Information

To develop an initial BCR, or to update an existing BCR, the rating analyst may gather detailed public and proprietary financial information and use this information to develop a tailored meeting agenda for a rating meeting. A scheduled rating meeting with the company is a key source of additional quantitative and qualitative information, including the clarification of information previously received or obtained. Key executives are present to discuss their areas of responsibility, including strategy, distribution, underwriting, reserving, investments, claims, enterprise risk management (ERM), and overall financial results and projections.

Material Sources of Information

In arriving at a rating decision, AM Best relies primarily on information provided by the rated entity, although other sources of information may be used in the analysis. Typical information provided includes a company's annual and quarterly (if available) financial statements, presented in accordance with the customs or regulatory requirements of the country of domicile. Other information and documents that may be reviewed include, but are not limited to: interim management reports on emerging issues, regulatory filings, certified actuarial and loss reserve reports, investment guidelines, internal capital models, Own Risk and Solvency Assessment (ORSA) reports, annual business plans, Best's Supplemental Rating Questionnaire (SRQ) or other supplemental information requested by AM Best, information provided through scheduled rating meetings and other discussions with management, and information available in the public domain. Ultimately, if AM Best is unable to obtain the information deemed necessary to appropriately review and analyze the rated entity (before or after the initial rating release or subsequent rating update) or if the quality of the information is deemed unsatisfactory, AM Best reserves the right to take a rating action based on reasonable assumptions, withdraw any existing interactive rating, or cease the initiation of any new BCR.

Perform Analysis

The analytical process incorporates a host of quantitative and qualitative measures that evaluate potential risks to an organization's financial health, which can include underwriting, credit, interest rate, country, and market risks, as well as economic and regulatory factors. The analysis may include comparisons to peers, industry standards, and proprietary benchmarks, as well as the assessment of operating plans, philosophy, management, risk appetite, and the implicit or explicit support of a parent or affiliates.

Determine the Rating

All BCRs are initially determined and subsequently updated by a rating committee. The rating analyst prepares a rating recommendation for rating committee review and deliberation based on the analytical process outlined in **Part III: The Rating Process**. Each rating recommendation is reviewed and modified, as appropriate, through a rigorous committee process that involves a rating analyst presenting information and findings to committee members. All rating recommendations are voted on and approved by committee. Rating committee members are all rating analysts who have the relevant skills and knowledge to develop the type of rating opinion being discussed. Rating opinions reflect a thorough analysis of all information known by AM Best and believed to be relevant to the rating process.

For BCRs intended to be made public, the rating committee determination is communicated to the entity (or its representatives) being rated before being publicly disseminated. Private BCRs are disseminated directly to the company following the conclusion of the rating committee.

Disseminate the Rating

The primary distribution method for the public dissemination of BCRs is the AMB website; in some cases, it may be republished by a press release. Notification of the rating committee determination to the requesting party serves as the dissemination of a private BCR.

Monitor Activities

Once an interactive BCR is disseminated publicly or privately, AM Best monitors and updates the rating by regularly analyzing the company's creditworthiness. Rating analysts monitor current entity-specific developments (e.g., financial statements, public documents, news events) and trending industry conditions to evaluate their potential impact on ratings. Significant developments can result in an interim rating evaluation, as well as modification of the rating or outlook.

C. Assumptions

Based on historical experience and AM Best's transition studies, ratings typically move no more than one or two notches when rating actions occur. However, certain factors may cause larger scale movement in the ratings. AM Best identifies the following primary factors as having the potential to significantly affect ratings:

- Data accuracy and reliability
- Interest rates
- Investment impairments
- Liquidity
- Equity markets
- Catastrophe model risk
- Reinsurance market capacity and credit risk
- Mortality risk
- Morbidity risk
- Insurance holding company (IHC)/affiliates
- Country risk
- Regulatory risk

D. Best's Credit Rating Approach

AM Best assigns various types of BCRs (FSRs, ICRs, and IRs) to a wide variety of organizations, from single legal entity insurers to complex, multinational enterprises with diversified insurance and non-insurance operations; multiple intermediate holding companies; and either a publicly traded or privately held ultimate IHC.

An ICR is an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis. An ICR is an opinion regarding the relative future

credit risk of an entity; credit risk is the risk that an entity may not meet its contractual financial obligations as they come due. An FSR is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An IR is an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis. When assigned to a specific issue, an IR is an opinion of the ability of the issuer/obligor to meet the ongoing financial obligations to security holders when due.

Examining an organization from both the top down and bottom up is fundamental to assigning a BCR and assessing the material risks to the rated entity. The process of determining an operating company ICR is described in **Part III: The Rating Process**.

The operating company ICR is the foundation for the operating company FSR and the IHC ICR. The operating company FSR is determined using the Rating Translation Table (**Exhibit D.1**), which effectively converts the rating from the ICR scale to the FSR scale. If an insurer issues public debt, AM Best may assign a rating specific to the credit quality of the debt issue. The IR is established by reference to the ICR of the issuing entity. For debt issued by an operating insurance company, the IR will reflect the degree of subordination of the debt issue to the senior obligations of the insurer, typically insurance policies and contracts.

Exhibit D.1: Rating Translation Table

Long-Term ICR	FSR
aaa	A++
aa+	
aa	A+
aa-	
a+	A
a	
a-	A-
bbb+	B++
bbb	
bbb-	B+

Long-Term ICR	FSR
bb+	B
bb	
bb-	B-
b+	C++
b	
b-	C+
ccc+	C
ccc	
ccc-	C-
cc	
c	D

Part II: Rating Units

Outline

A. Introduction to Rating Units
B. Pooled Ratings – (p) Affiliation Code
C. Reinsured Ratings – (r) Affiliation Code
D. Group Ratings – (g) Affiliation Code
E. Designation of the Lead Rating Unit
F. Branches

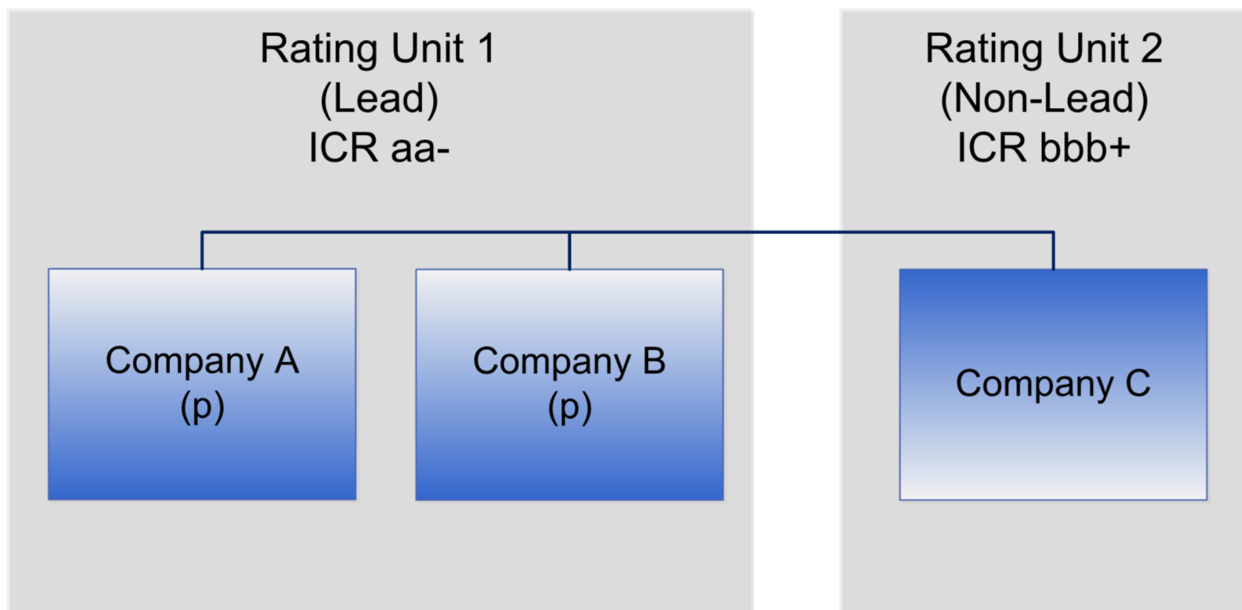
A. Introduction to Rating Units

AM Best uses the concept of a "rating unit" in evaluating members of insurance groups. The conceptual foundation for a rating unit is the recognition that the financial fortunes of certain insurance group members may be so intertwined that they are most appropriately analyzed as a whole. This analytical approach may allow consideration of the benefits that weaker entities in the group derive from the group structure, while also accounting for the expectation of support, and the burden of that support, drawn from stronger members. It also considers the impairment history of insurance groups; failure has historically been a group-wide issue rather than affecting just individual entities in a larger group. However, AM Best recognizes that default occurs from a legal standpoint at the entity level. Thus, identifying the point at which multiple entities should be considered a rating unit for analytical purposes can be a challenge, not least because the contractual interconnections of individual legal entities in a group may be very complex and can span many years.

The rating unit determination, therefore, begins with understanding the organization's overall structure and then considering a number of factors as they may apply to particular group members, including the following: pooling arrangements; intra-group reinsurance contracts; guarantees and net worth maintenance agreements, and other connections among the affected group members with regard to branding, types of business written, manner of distribution, geographic territories served, time in the group, strategic value and infrastructure. In substance, the process amounts to developing a view as to how easily certain group entities can be separated and the impact that a default by one or more of the separated entities or subgroup would have on the remainder. If separation were to be difficult because of intra-group connections, and a default on any part were to be damaging to the whole or to some multi-entity grouping within the whole, a rating unit of multiple insurance entities would be constructed and used in the rating analysis.

A rating unit may be composed of one or multiple insurance entities (**Exhibit A.1**).

Exhibit A.1: Example of Rating Units Composed of One or Multiple Insurance Entities



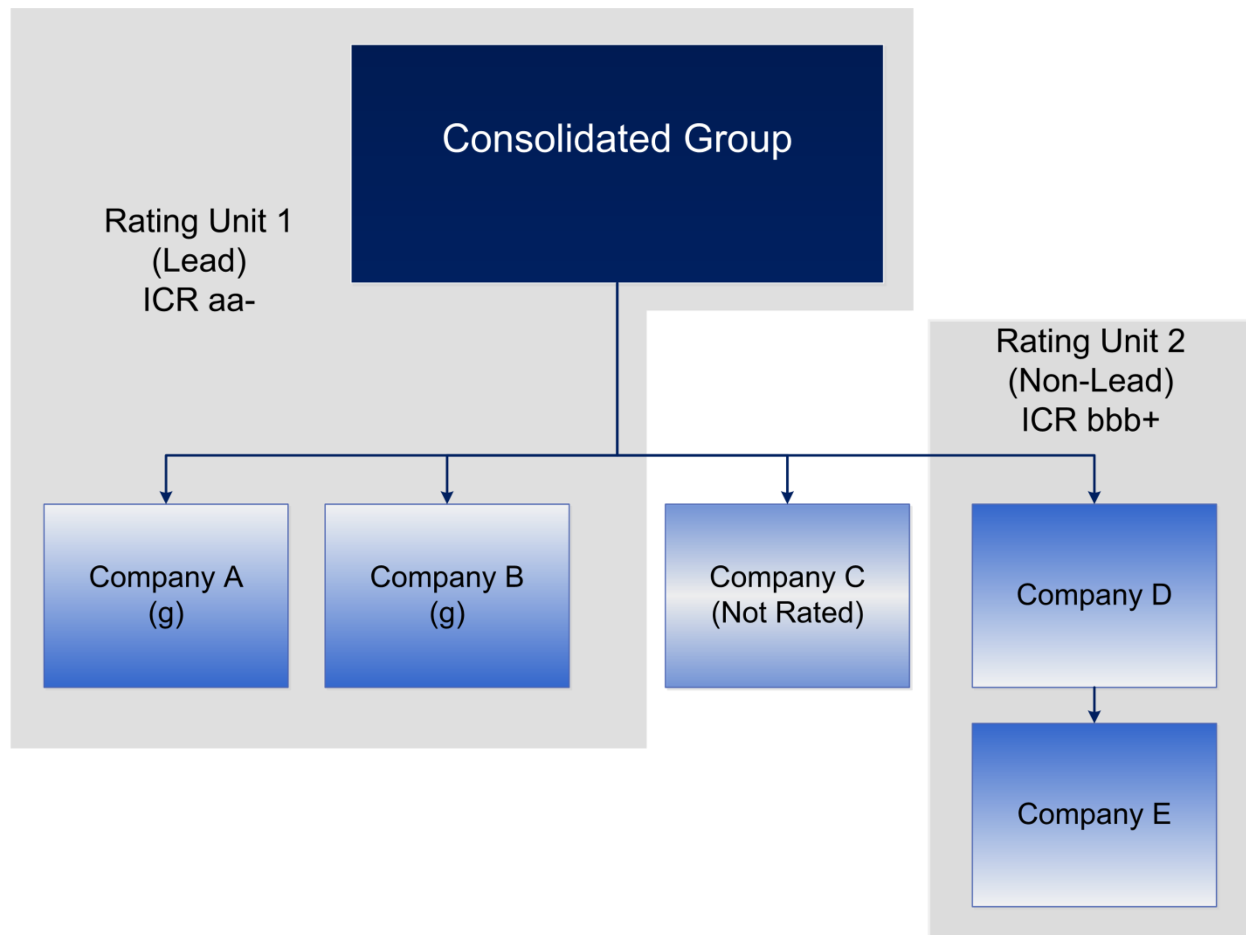
When a rating unit is composed of several selected insurance entities (i.e., not necessarily based on a consolidated group as explained below), all members of the rating unit will receive the same ICR and FSR. Additionally, in that case, each insurer in the rating unit will have met the criteria for and will be assigned one of the following:

1. A pooled (p) affiliation code
2. A reinsured (r) affiliation code
3. A group (g) affiliation code

Assignment of the pooled (p) and reinsured (r) affiliation codes includes a thorough review of the relevant pooling or reinsurance agreement. Assignment of a group (g) affiliation code often includes an analysis of many qualitative and quantitative factors related to the company's strategic role in the rating unit.

A rating unit could also be created based on a consolidated group of (re)insurance companies in their entirety (**Exhibit A.2**). The consolidation that comprises the analysis of the rating unit may include entities not rated by AM Best and/or entities dedicated to ancillary or supplementary activities. Whether rated entities that comprise the consolidation receive an affiliation code would depend on their importance to the group and/or their contractual agreements.

Exhibit A.2: Example of Rating Units Created Based on a Consolidated Group



If a rating unit comprises two or more insurers, the analysis of the rating unit will be based on the combined assessment of the entities. In addition, for complex, multinational organizations, analysis may also be complemented by additional work at the legal entity/sub-group/geographical level. This process may include, but is not limited to, meeting the local management of large multinational rating units, reviewing capital and earnings trends, and developing an understanding of local market conditions. This more granular input may ultimately have an impact on the overall rating unit assessment.

The determination of all rating units and the review for eligibility of all (p), (r), and (g) affiliation codes takes place before the steps described in **Part III: The Rating Process**. When determining rating units, each legal entity is reviewed to determine whether the current (p), (r), and (g) affiliation codes are still appropriate or if different insurance entities are eligible to be assigned one of these affiliation codes.

B. Pooled Ratings – (p) Affiliation Code

A group whose member companies pool assets, liabilities, and operating results maintains, in theory, the same operating performance and balance sheet strength across all companies in 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 assigned a pooled (p) affiliation code by AM Best generally contain the following provisions:

- Provide joint and several liability (or reapportionment language)
- Share of all gross premiums, losses, and expenses based on 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)
- Coverage for any prior-year loss reserve development exposure
- Coverage for the runoff of all liabilities incurred on policies incepted prior to termination
- Have 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 requirement of at least 90 days' notice before the pool can be disbanded or a company can be removed from it

C. Reinsured Ratings – (r) Affiliation Code

AM Best assigns the reinsured (r) rating affiliation code to a company in a group that reinsures substantially all its insurance risk with an affiliated reinsurer. Intercompany reinsurance agreements that qualify for the reinsured (r) rating affiliation code generally contain the following provisions:

- Quota share of all gross premiums, losses, and expenses written by the company unless regulatory restrictions apply (cases with applicable regulatory restrictions are subject to additional review; in these instances, AM Best expects to review regulatory documentation, and the retained percentage could be as high as the level required by regulation, provided this does not exceed a maximum of 20%)
- A contract that contains no loss caps or loss corridors
- Requirement of at least 90 days' notice before the reinsurance agreement can be terminated
- A reinsurance contract that 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

- Common ultimate ownership by the assuming company with the reinsured company, or common control through the board of directors together with common management

D. Group Ratings – (g) Affiliation Code

A(n) (re)insurance company in a rating unit that is assigned the group (g) affiliation code is viewed as integral to the group's primary business due to its financial, operational, and/or strategic importance. The assessment of the (re)insurance company's importance to the overall organization considers whether the insurer meets most of the following criteria:

- It is critical to the group's strategy and ongoing success
- It is fully integrated into the group's operations and management
- It is material to the group's business profile
- Its divestiture would lead to a major shift in business strategy
- It carries the group name or is easily identified with the group
- It is a significant contributor to the group's earnings
- The parent would be willing to provide explicit support
- It has a track record of supporting the group's strategy
- It is necessary for rate flexibility
- It is necessary for licensing

In addition to these items, AM Best also considers whether the group demonstrates its commitment to an entity through the use of explicit financial support during the (g) review. Such support can take the form of a capital contribution or a contractual arrangement that exhibits commitment, regardless of the entity's fundamental importance to the group. The evaluation of explicit support includes a subjective review of the expected permanence of commitment to an entity. Examples of explicit support may include the following:

- Significant net quota share within the group
- Material stop loss agreement with parent or affiliate
- Capital management initiatives such as earnings retention or material capital injection in the previous five years (excluding initial capitalization)
- Guarantee or net worth maintenance agreement

In the case of explicit financial support such as guarantees, AM Best would view that policyholders are generally more protected when the guarantee contains the following: coverage for all financial obligations of the entity; clear and satisfactory resolution to any foreseeable regulatory/jurisdictional conflicts; 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.

For those insurers that have received a (g) affiliation code, AM Best expects that the group would continue to support that insurer, to the extent of its financial ability, in almost any eventuality. The sale or closing of an insurer that has received a (g) would imply an unexpected shift in the group's strategy. To ensure that the assignment of a (g) continues to be appropriate, AM Best maintains contact with company management and monitors each company's performance and its strategic role in the group.

Non-eligibility for a (g) Affiliation Code

Examples of factors that may prevent an insurer from being considered a part of the rating unit (although its financials may still be part of the consolidation) include the following:

- Unexpected, weakened capitalization, which can be interpreted as a loss of commitment or change in the fungibility of capital
- Capitalization at levels significantly weaker than the members of the rating unit (although the level of capital may be viewed in light of standards set by prudential regulatory authorities in countries deemed to have strong insurance regulation)
- Volatile earnings, linked to a business that is not core to the rating unit
- Restrictions on the free flow of capital
- Doubts over future financial support
- Pending sale of the insurer
- Diminished business profile or a change in business strategy or risk appetite

New companies or entities acquired within the last 24 months are generally not eligible for the (g) affiliation code, as they are unlikely to have made a material contribution to the group's earnings, be fully integrated within the rest of the rating unit or be critical to the group's strategy. In these cases, a start-up or recently acquired entity would typically need to benefit from explicit parental support (such as affiliated reinsurance or a financial guarantee) and satisfy the criteria above to be assigned a group (g) affiliation code.

E. Designation of the Lead Rating Unit

As part of its assessment of an insurer's financial strength, AM Best uses its consolidated view of the organization to conduct an enterprise-level analysis. This analysis considers strengths and weaknesses that may reside not only within the insurance entities, but also at the IHC or at a non-insurance affiliate. When an organization contains more than one rating unit, the rating analyst designates a lead rating unit based on its importance in the organization. The lead rating unit designation may also be based on the consolidated analysis of the group. In this case, the consolidated assessment would determine the rating to be assigned to the members of the lead rating unit. A consolidated financial

view would indicate the highest possible rating within the group from lift (when applicable). Any other rated insurance legal entities not included in the lead rating unit would be viewed as members of "non-lead" rating units.

A rating unit based on a consolidated group will always be considered the lead rating unit for that group. Under special circumstances, it is possible for a non-lead rating unit to obtain a rating higher than that of the lead rating unit. This might occur when the non-lead rating unit consists of a sub-group that specializes in a particular business—which is clearly identifiable and separate from that of the rest of the group—and is (normally) subject to a different regulatory framework and jurisdiction, or governance framework, with clear restrictions—either regulatory or demonstrated by its track record—on the flow of capital within the wider group.

F. Branches

A branch is not viewed as a separate legal entity, but as an extension of the head office. As such, policies are written on the paper of the legal entity of which the active branch is a part. Therefore, a rated branch maintains the rating of the head office. The ratings apply to all insurance policies issued by an insurer as a single class of obligation. In effect, AM Best's rating opinion applies to the last policyholder in the event of liquidation.

Part III: The Rating Process

Outline

A. **The Rating Process Overview**
B. **Balance Sheet Strength**
C. **Operating Performance**
D. **Business Profile**
E. **Enterprise Risk Management**
F. **Comprehensive Adjustment & Preliminary Assessment**
G. **Rating Lift/Drag**
H. **Recommended ICR**

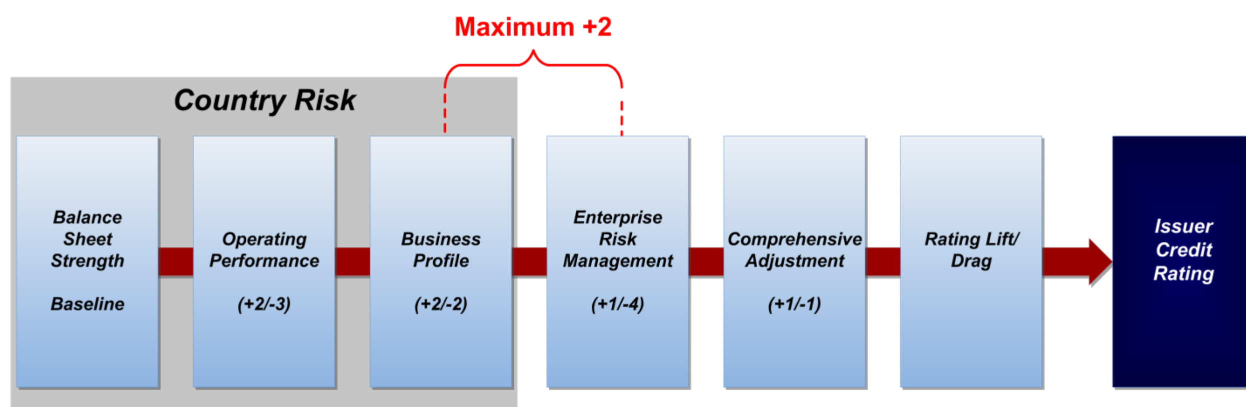
A. The Rating Process Overview

The assignment of an Issuer Credit Rating (ICR) consists of a comprehensive quantitative and qualitative analysis of the following key rating factors: balance sheet strength, operating performance, business profile, enterprise risk management (ERM), and (if applicable) rating lift/drag. The analysis required to determine an ICR is conducted at the rating unit level. For those enterprises with multiple rating units, a lead rating unit is identified. The lead rating unit is normally the largest or most strategically important member of an insurance group. The analysis begins with a review of the strengths and weaknesses of the lead rating unit.

From a process standpoint, the first step in the development of a rating recommendation is an evaluation of balance sheet strength. The steps described in the balance sheet strength section result in a baseline assessment, which is represented on the ICR scale (e.g., bbb+). Next, the other key rating factors—operating performance, business profile, and ERM—are evaluated with support based on information compiled by the rating analyst. The impact of country risk is assessed during the review of balance sheet strength, operating performance, and business profile. The analysis of each of these rating factors results in a positive, negative, or neutral adjustment from the baseline assessment, subject to stated constraints. In certain cases, it may be difficult to attribute the adjustment exclusively to one of the building blocks (e.g., the rating unit may show strong results due to both operating performance and business profile at the same time). In these situations, analytical judgment may be applied to attribute the adjustment to the factor considered by the analyst most relevant in relative terms. If the rating unit has uncommon strengths or weaknesses that have not been captured in the rating process up to this point, a comprehensive adjustment can be made based on analytical judgment. For lead rating units, the analytical process is then complete and a recommended ICR is determined (with the exception noted under **Lift/Drag**). For non-lead rating units, the final step in the analytical process is an analysis of rating lift/drag. This analysis is conducted to ascertain the recommended ICR, as shown in **Exhibit A.1**.

Best's Credit Rating Methodology (BCRM)

Exhibit A.1: AM Best's Rating Process



Balance Sheet Strength

AM Best's rating analysis begins with an evaluation of the rating unit's balance sheet strength. Balance sheet strength is viewed as the foundation for financial security; thus, its evaluation is critical when determining a rating unit's ability to meet its current and ongoing obligations. The evaluation of balance sheet strength includes an analysis of three main areas: 1) the insurance rating unit; 2) the financial flexibility and risks associated with the IHC and/or ownership structure; and 3) the impact of country risk on balance sheet strength.

Rating Unit

The balance sheet strength analysis at the rating unit level encompasses an assessment of capital adequacy, liquidity, reserve adequacy and investment risk. One of the primary tools used to evaluate an insurer's balance sheet strength is Best's Capital Adequacy Ratio (BCAR). BCAR is a quantitative measure of the risks inherent in the rating unit's investment and insurance operations relative to its available capital. The stability of a rating unit's BCAR over time is emphasized in the analysis. A relatively stable BCAR would be viewed more favorably than a BCAR with a pattern of volatility. Rating analysts may also have discussions about the use of an insurer's own internal capital model as part of this review.

While the BCAR remains a key component of the initial balance sheet strength assessment, other factors—such as dependence on reinsurance programs to support capital, diversification and quality of assets, and liquidity—are also evaluated. This analytical review can include an assessment of the rating unit's reliance on reinsurance, operating or financial leverage, and tangible capital. The rating analyst will arrive at a balance sheet strength assessment for the insurance rating unit after evaluating the key characteristics described in **Exhibit A.2**.

Exhibit A.2: Balance Sheet Strength Assessment of the Rating Unit

Assessment	Key Characteristics
Strongest	The rating unit has the strongest BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also the strongest. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of strongest.
Very Strong	The rating unit has a very strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also very strong. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of very strong.
Strong	The rating unit has a strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also strong. It has an appropriate and diverse reinsurance program. Any additional factors are in line with an assessment of strong.
Adequate	The rating unit has an adequate BCAR score that has been relatively stable. Its quality of capital and ALM are adequate. It has an appropriate reinsurance program. Any additional factors are in line with an assessment of adequate.
Weak	The rating unit has a weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are weak. Its reinsurance program is weak. Any additional factors are in line with an assessment of weak.
Very Weak	The rating unit has a very weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are very weak. Its reinsurance program is very weak. Any additional factors are in line with an assessment of very weak.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Insurance Holding Company (Lead Rating Unit Only)

The financial health of the enterprise/organization is evaluated as part of the balance sheet strength assessment. This analysis involves a review of the impact of the IHC and/or affiliates on the lead rating unit. Insurance holding companies and their capital structures can have a significant impact on a subsidiary's overall financial strength and are therefore included in the analysis of the lead rating unit's balance sheet strength. IHCs can provide subsidiaries with a degree of financial flexibility through capital infusions, access to capital markets, and, in some cases, additional cash flow from other operations. Conversely, debt and other securities are typically the IHC's obligations and can diminish the enterprise's financial flexibility, strain future earnings, and inhibit subsidiary surplus growth.

When reviewing the IHC, AM Best considers the financial strength of the parent (generally including the IHC's BCAR, internal capital models or other capital adequacy measures), financial flexibility, liquidity, financial leverage, interest coverage, dividend requirements, and cash sources and uses (including unregulated non-insurance subsidiaries) to determine the effect on the lead rating unit.

When no IHC exists, as in the case of an operating holding company, these same factors are evaluated with respect to the lead rating unit.

These factors are analyzed on a historical and prospective basis to establish whether the IHC has a positive, neutral, negative, or very negative effect on the balance sheet strength assessment of the lead rating unit. The weighting of the factors will vary; if any factor(s) is/are deemed to be significantly adverse, the IHC assessment could be negative or very negative (**Exhibit A.3**).

Exhibit A.3: Impact of Insurance Holding Company on Balance Sheet Strength Assessment

Assessment	Key Characteristics
Positive	The consolidated BCAR is supportive of or exceeds that of the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are high. Financial leverage is low on both an adjusted and unadjusted basis. Interest coverage is more than adequate.
Neutral	The consolidated BCAR is consistent with the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are adequate. Financial leverage is acceptable on both an adjusted and unadjusted basis. Interest coverage is adequate.
Negative	The consolidated BCAR score is inadequate relative to the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are low. Financial leverage is high on either an adjusted or unadjusted basis. Interest coverage is inadequate.
Very Negative	The consolidated BCAR indicates a poor financial position relative to the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are very low. Financial leverage is very high on either an adjusted or unadjusted basis. Interest coverage is inadequate.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

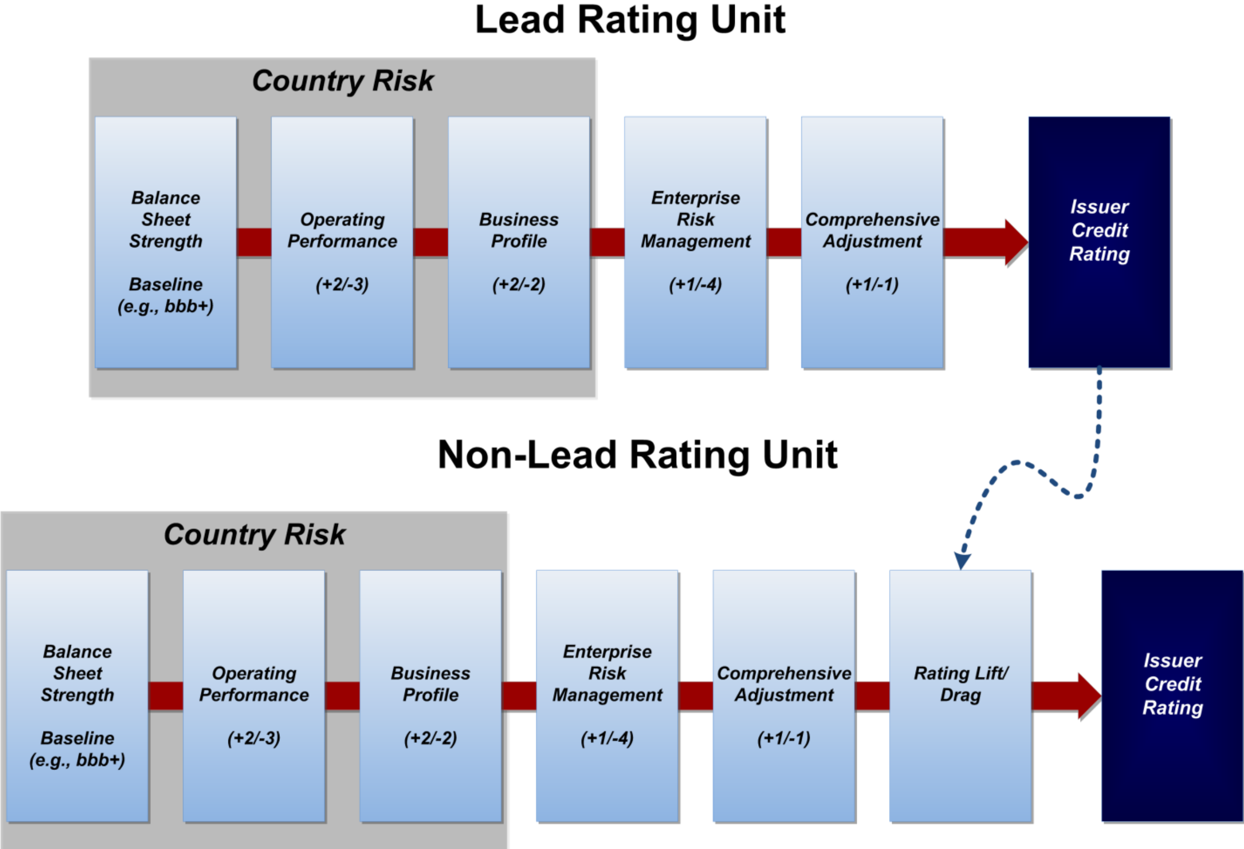
Once the IHC analysis is completed, the result is integrated with the balance sheet strength assessment of the lead rating unit. The initial view of the balance sheet strength of the lead rating unit may change when the view of the IHC is incorporated. For example, a "Positive" assessment of the IHC's impact can increase the lead rating unit's balance sheet strength assessment from "Adequate" to "Strong". Similarly, a negative IHC assessment can lower the assessment of the lead rating unit's balance sheet strength from "Strong" to "Adequate" (**Exhibit A.4**).

Exhibit A.4: Combined Balance Sheet Strength Assessment

Lead Rating Unit	Insurance Holding Company: Positive	Neutral	Negative	Very Negative
Strongest	Strongest	Strongest	Very Strong	Adequate
Very Strong	Strongest	Very Strong	Strong	Weak
Strong	Very Strong	Strong	Adequate	Very Weak
Adequate	Strong	Adequate	Weak	Very Weak
Weak	Adequate	Weak	Very Weak	Very Weak
Very Weak	Weak	Very Weak	Very Weak	Very Weak

Although multiple rating units may exist within an enterprise/organization, the IHC will affect the balance sheet strength assessment of only the lead rating unit. For more complex ownership structures that include rating units other than the lead rating unit, the impact of the IHC/ownership structure on balance sheet strength will not directly affect the assessment of a non-lead rating unit's financial position either positively or negatively. Instead, the non-lead rating units will be eligible to receive rating lift or drag from the lead rating unit later on in the rating process. **Exhibit A.5** depicts the process.

Exhibit A.5: The Rating Process – Lead Rating Unit vs. Other Rating Units



Country Risk

Before completing a rating assessment, the country risk associated with a rating unit must be determined. In most instances, a company's country risk tier will be determined by country of domicile. There are cases when a company's country risk profile is more accurately reflected by a blending of tiers. Tier blends include the company's domicile as well as country of operations (regulation, asset, and insurance exposure) and must be incorporated into the analysis of balance sheet strength, operating performance, and business profile. AM Best defines country risk as the risk that country-specific factors will adversely affect an insurer's ability to meet its financial obligations and separates these factors into three main categories of risk: economic risk, political risk, and financial system risk. Countries are placed into one of five tiers, ranging from CRT-1 (Country Risk Tier 1) to CRT-5 (Country Risk Tier 5). CRT-1 countries are those with a stable environment and therefore the least amount of risk, while CRT-5 countries pose the most risk and therefore the greatest challenge to an insurer's financial stability, strength, and performance.

Country risk plays an important role in setting the rating range for the baseline assessment. The level of consideration given to country risk (i.e., its potential impact on the assessments of balance sheet strength, operating performance, and business profile) is determined on a case-by-case basis for each

rating unit, based on its financial strength, position in the market, and ability to mitigate or manage its exposure to country risk. Companies domiciled, conducting business, and/or with asset exposure in higher-risk countries are subject to more volatile external conditions, as business cycles are amplified. In these countries, a strong initial capital position can erode more quickly; thus, the initial rating range of a well-capitalized insurance rating unit domiciled and/or operating in a high-risk country will be lower than the initial rating range of an insurer in a low-risk country. AM Best does not place a cap on the insurance rating based on the sovereign debt rating of the country in which the rating unit is domiciled or to which it is materially exposed; however, movements from one CRT to another do affect the overall assessment of balance sheet strength, as illustrated in **Exhibit A.6**.

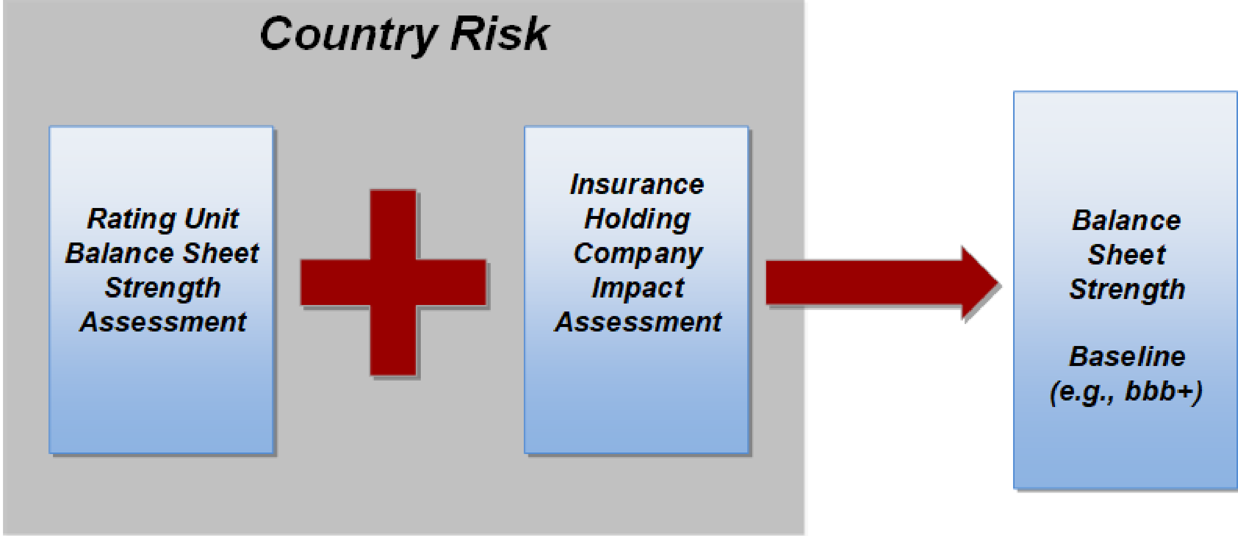
Using the combined assessment of balance sheet strength for the rating unit/IHC and the appropriate CRT, the rating analyst selects a baseline rating assessment as described in **Exhibit A.6**.

Exhibit A.6: Overall Balance Sheet Strength Assessment

Combined Balance Sheet Assessment (Rating Unit/ Insurance Holding Company)	Country Risk Tier				
	CRT-1	CRT-2	CRT-3	CRT-4	CRT-5
Strongest	a+/a	a+/a	a/a-	a-/bbb+	bbb+/bbb
Very Strong	a/a-	a/a-	a-/bbb+	bbb+/bbb	bbb/bbb-
Strong	a-/bbb+	a-/bbb+	bbb+/bbb/bbb-	bbb/bbb-/bb+	bbb-/bb+/bb
Adequate	bbb+/bbb/bbb-	bbb+/bbb/bbb-	bbb-/bb+/bb	bb+/bb/bb-	bb/bb-/b+
Weak	bb+/bb/bb-	bb+/bb/bb-	bb-/b+/b	b+/b/b-	b/b-/ccc+
Very Weak	b+ and below	b+ and below	b- and below	ccc+ and below	ccc and below

The rating analyst has discretion when choosing within the ranges presented in **Exhibit A.6** for their recommendation to the rating committee depending on the strength of the overall balance sheet. The complete process of arriving at the assessment for balance sheet strength (i.e., the baseline assessment) is illustrated in **Exhibit A.7**.

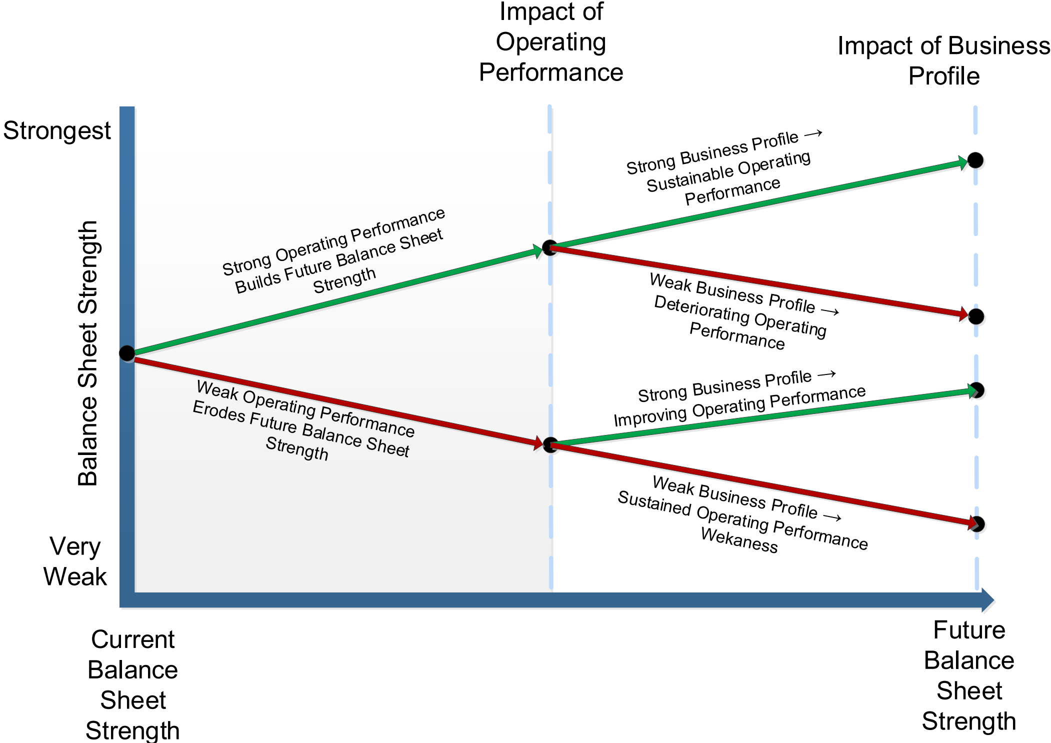
Exhibit A.7: Steps to Completing the Assessment of Balance Sheet Strength



Operating Performance

Without solid operating performance and business profile, a company's balance sheet strength will erode over time. **Exhibit A.8** illustrates the impact that operating performance and business profile can have on future balance sheet strength.

Exhibit A.8: Impact of Operating Performance and Business Profile on Balance Sheet Strength



AM 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 business strategy. A rating unit with strong performance over time will generate earnings sufficient to maintain a prudent level of risk-adjusted capital and optimize stakeholder value. Strong performers are those companies whose earnings are relatively consistent and deemed sustainable. As such, a rating unit's operating performance and performance variability are analyzed on an absolute basis, while accounting for any impact from the country risk analysis, and compared against appropriate benchmarks. Generally, a rating unit with sustainable and considerably better and less volatile performance versus the appropriate benchmark will receive a relatively stronger operating performance assessment. Similarly, a rating unit with performance that is significantly inferior and displays more variability relative to the benchmark will typically receive a weaker operating performance assessment.

The analysis of operating performance can result in an increase, decrease, or no change in the baseline assessment. The degree of change can be significant and move the assessment up a maximum of two notches or down a maximum of three notches. Analytical judgment of prospective performance is factored into the final assessment.

Exhibit A.9: Operating Performance Assessment

Assessment	Notches	Key Characteristics
Very Strong	+2	Historical operating performance is exceptionally strong and consistent. Trends are positive and prospective operating performance is expected to be exceptionally strong. Volatility of key metrics is low.
Strong	+1	Historical operating performance is strong and consistent. Trends are neutral/slightly positive and prospective operating performance is expected to be strong. Volatility of key metrics is low to moderate.
Adequate	0	Historical operating performance and trends are neutral. Prospective operating performance is expected to be neutral. Volatility of key metrics is moderate.
Marginal	-1	Historical operating trends have been inconsistent. Trends are neutral/slightly negative with some uncertainty in prospective operating performance. Volatility of key metrics is moderate to high.
Weak	-2	Historical operating performance is poor. Trends are slightly negative and prospective operating performance is expected to be poor. Volatility of key metrics is high.
Very Weak	-3	Historical operating performance is very poor. Trends are negative and prospective operating performance is expected to be very poor. Volatility of key metrics is very high.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Business Profile

After concluding the operating performance review, the rating analyst conducts an assessment of the rating unit's business profile. The business profile assessment can result in an increase, decrease, or no change in the rating. Potential factors reviewed in the analysis of a rating unit's business profile include market position; degree of competition; control of distribution channels; pricing sophistication and data quality; underwriting culture; management quality; business strategy; product/geographic concentration; product risk; and regulatory, event, market, and country risks as well as innovation. When the review is complete, the rating analyst will select a business profile assessment that encapsulates the analysis of these factors (**Exhibit A.10**).

Up to this point in the rating process, highly rated companies should have strong balance sheets, solid operating performance, and stable operating trends. What distinguishes the highest-rated companies from lower-rated insurers is the strength of their business profiles, which typically translates into defensible competitive advantages. A very favorable (or very limited) business profile can increase (or decrease) the rating a maximum of two notches.

Exhibit A.10: Business Profile Assessment

Assessment	Notches	Key Characteristics
Very Favorable	+2	The company's market leadership position is unquestionable, demonstrated, and defensible with high brand recognition. Distribution and innovation efforts have resulted in a competitive advantage; business lines are non-correlated and generally lower risk. Its management capabilities and data management are very strong.
Favorable	+1	The company is a market leader with strong business trends and good control over distribution. It has diversified operations in key markets that have high to moderate barriers to entry with low competition. It has a strong management team that is able to meet projections and utilize data and innovations effectively.
Neutral	0	The company is not a market leader but is viewed as competitive in chosen markets. It has some concentration and/or limited control of distribution. It has moderate product risk but limited severity and frequency of loss. Its use of technology and innovation is evolving and its business spread of risk is adequate.
Limited	-1	The company has a lack of diversification in geographic and/or product lines; its control over distribution is limited and undifferentiated. It faces high/increasing competition with low barriers to entry and elevated product risk. Management is unable to utilize data and leverage innovations effectively or consistently in business decisions.
Very Limited	-2	The company faces high competition and low barriers to entry. It has high concentration in commodity or higher-risk products with very limited geographic diversity. It has weak data management and its innovation activities or lack thereof has a negative impact on its business profile. Country risk may factor into its elevated business profile risks.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Enterprise Risk Management (ERM)

The impact of enterprise risk management (ERM) on an insurer's rating is based on an understanding of the development and implementation of an insurer's risk management framework and of the insurer's risk management capability relative to its risk profile. AM Best views the management of an organization's exposure to potential earnings and capital volatility, and the maximization of value to the organization's various stakeholders as the fundamental objectives of an ERM program. ERM allows organizations to identify and quantify their risks, set risk tolerances based on their overall corporate objectives, and take the necessary actions to manage risk in light of those objectives. As such, if a rating unit is practicing sound ERM and executing its strategy effectively within its stated risk tolerances, it will preserve and build its balance sheet strength and perform successfully over the long term.

The analysis of ERM can result in an increase, decrease, or no change in the rating. **Exhibit A.11** shows that very strong ERM can increase the assessment by a maximum of one notch, and very weak ERM can decrease the assessment by up to four notches. The downside spread in notching reflects AM Best's concern that truly weak ERM can disproportionately affect future financial strength and performance.

Companies with complex business profiles have a need for a robust and comprehensive ERM program. In many cases, the complexities and demands of these companies' "Very Favorable" business profiles require an equally "Very Strong" ERM. Acknowledging this interaction, and the limited impact that these two highly qualitative building blocks may have on credit strength, the combined impact between business profile and ERM is limited to a maximum of "+2" notches. This calculation would only affect those companies that have both a "Very Favorable" business profile assessment and a "Very Strong" ERM assessment.

Exhibit A.11: Enterprise Risk Management Assessment

Assessment	Notches	Key Characteristics
Very Strong	+1	The insurer's ERM framework is embedded. The insurer demonstrates market best practice techniques. The results are evident in a prudent and stable level of net required capital and successful performance over the long term. Risk management capabilities are very strong and are suitable for the risk profile of the company.
Appropriate	0	The insurer's ERM framework is developed. Risk management capabilities are well aligned with the risk profile of the company.
Marginal	-1	The insurer's ERM framework is evolving. Risk management capabilities show some weakness in key risk areas.
Weak	-2	The insurer's ERM framework contains some nascent elements. Risk management capabilities are largely not aligned with the risk profile of the company.
Very Weak	-3/4	The insurer's ERM framework is unrecognized. Risk management capabilities relative to the risk profile of the company are not aligned.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Comprehensive Adjustment

After the ERM analysis, a comprehensive adjustment may on occasion be made to the assessment. This adjustment accounts for situations in which, based on a comparison to similar companies, the creditworthiness of the rating unit exceeds (or is less than) what was captured through the rating process to this point. A comprehensive adjustment can increase or decrease the current assessment by a maximum of one notch (**Exhibit A.12**).

Exhibit A.12: Comprehensive Adjustment Assessment

Assessment	Notches	Key Characteristics
Positive	+1	The company has uncommon strengths that exceed what has been captured throughout the rating process.
None	0	The company's strengths and weaknesses have been accurately captured throughout the rating process.
Negative	-1	The company has uncommon weaknesses that exceed what has been captured throughout the rating process.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Rating Lift/Drag

The assessment of lift/drag can impact either the lead rating unit or the non-lead rating unit. Given that the impact of an IHC on the lead rating unit is assessed in balance sheet strength, no additional rating lift or drag is generally given to the lead rating unit in this step. However, in cases where there is ownership of the lead rating unit by a non-insurance parent, the rating lift/drag assessment would capture any impact (negative or positive) from the non-insurance parent since this impact has not yet been captured up to this point.

For non-lead rating units, the same process as the lead rating unit (i.e., a review of balance sheet strength, operating performance, business profile, ERM, and the comprehensive adjustment) has occurred up to this point. In this step, however, the lead rating unit may afford lift or drag to the non-lead rating unit based on factors such as integration, strategic importance, and contribution to the overall enterprise.

In both situations described above, (lead or non-lead rating unit) determining eligibility for rating lift involves evaluating implicit and explicit support. If the rating unit is well-integrated within the organization with respect to management, infrastructure, and systems, the rating analyst may recommend that since the rating unit has the implicit support of the broader organization, it is eligible for rating lift. Similarly, an agreement to provide explicit financial support (e.g., a guarantee or net worth maintenance agreement) may also allow for rating lift. Companies that receive more 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 situations where the lead rating unit's financial strength is weaker than the non-lead rating unit, the non-lead rating unit may be penalized for its association with the broader organization and receive drag. Drag to the lead rating unit may also occur from the impact of the non-insurance parent. Considerations in determining whether drag is not applicable include restrictions for withdrawing capital from the subsidiary, any protection provided to the subsidiary through independent directors or control through unrelated stakeholders, regulatory restrictions, commitments through independent public listings and disclosures, and other measures that may protect the balance sheet of the company.

Exhibit A.13 describes typical adjustments to the preliminary assessment as a result of rating lift or drag.

Exhibit A.13: Rating Lift/Drag Assessment

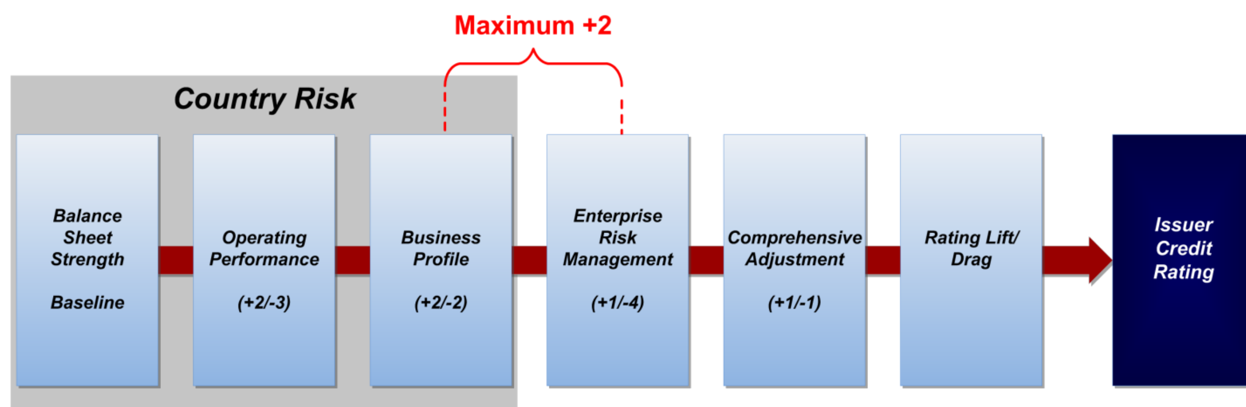
Assessment	Notches	Key Characteristics
Typical Lift	+1 to +4	The rating unit receives explicit support from the financially stronger broader organization and/or is deemed materially important to it, as demonstrated by its level of integration.
Neutral	0	The rating unit does not receive explicit support from the broader organization of similar or higher financial strength and/or is not considered materially important to it.
Typical Drag	-1 to -4	The rating unit is negatively impacted by its association with the financially weaker broader organization.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

ICR

After the analysis of rating lift/drag is complete, the rating analyst has completed the rating recommendation process. The rating analyst (analytical team) then presents the recommended ICR to a rating committee. The committee determines the final rating outcome, which is the rating unit's ICR.

Exhibit A.14: AM Best's Rating Process



Characteristics of Highly Rated Insurers

While insurers can theoretically reach any rating after completing the process outlined above, the highest-rated insurers have the following characteristics, among others:

- Superior and stable risk-adjusted capitalization across the various confidence levels
- Strong, predictable, and sustainable operating profitability developed from a favorable lower-risk liability profile, with results exhibiting limited volatility
- Competitive advantage in branding, customer experience, investments, and/or underwriting

- Competitive market position leading to pricing power in core business lines
- Strong and stable operating cash flows, with books of business demonstrating favorable retention trends
- Diversified earnings and revenue streams
- Effective use of technology/data analytics which positively impacts performance
- Product design with flexibility/risk-sharing features to effectively react to changing market environments
- Market-leading distribution system
- Comprehensive and proactive enterprise risk management
- Consistent key metrics compared with peers
- Long-term, well-developed business strategy that has been tested over time
- Strong management team
- Key operations in stable regulatory environments

While many insurers may have favorable characteristics, a rating unit would be unlikely to achieve the highest possible ratings without the successful combination of the factors listed above. Whether the insurer has these characteristics should be evident throughout the analytical process noted under balance sheet strength, operating performance, business profile, enterprise risk management, and comprehensive adjustment.

Environmental, Social & Governance (ESG) Factors

"ESG" (environmental, social and governance) has gained significant traction to improve transparency of risks not captured by standard financial metrics so that informed choices can be made by stakeholders. Understanding and integrating ESG principles into strategy is becoming increasingly important for insurers. While there has been strong consideration for ethical and moral values, aspects such as sustainability and management of climate-related risks are prominent for the insurance industry. Insurers play a unique role within ESG as risk carriers, asset managers and institutional investors.

With no industry-wide ESG standards in place, it can be overwhelming for market players to fully understand how to implement and disclose ESG practices. Despite this, several factors usually considered ESG-related described below, are evaluated to determine their materiality in respect to a particular building block.

For climate-related risk there are three main areas of focus for the insurance market: physical, transition and liability related risks. Physical risk captures the changing frequency and intensity of weather-related events, transitional risk is associated with transition to a low-carbon economy and liability risk relate to possible increases in litigation arising from say, pollution or contamination. All these factors can impact the creditworthiness of an insurer and affect the financial strength,

performance and reputation of a company. In contrast, ESG can also create opportunities for the market as changes in customer preferences and lifestyles may create new product opportunities.

In forming its credit opinions, AM Best's analysis identifies key risks to insurers. This analytical process includes identifying the impact of climate risk on insurers' credit ratings, through an in-depth review of balance sheet strength, operating performance, business profile and enterprise risk management.

Balance Sheet Strength

Environmental factors are considered a severe threat to the balance sheet strength of property and casualty insurers because of the potentially significant, rapid and unexpected impact of such losses. In the context of environmental risk, AM Best generally classifies weather-related events such as hurricanes, cyclones, wildfires, droughts, storms and floods as events affected by climate risk. AM Best expects insurers accepting climate-related risk to be able to demonstrate that they can effectively manage it – including consideration for material impact from climate trends, with the potential for increased severity and frequency of weather-related events - and have the financial wherewithal to absorb potential losses.

Asset risk is another key component of the balance sheet strength assessment. From a credit rating perspective, AM Best will discuss how ESG is integrated into investment policy, whether negative screening takes place, and the company's commitment to green, sustainable or ethical investing. AM Best will also seek to understand whether the investment strategy improves diversification, or increases concentration within the asset portfolio, and if this translates into improved earnings. One concern over the medium–to-long term is exposure to stranded assets and a company's ability to transition its asset portfolio to ensure that there are limited write-downs due to these assets. An important point to make is that strong ESG integration does not necessarily translate into higher credit quality of an investment portfolio. For example, investments in untested technologies, start-ups or taking insurance risks that cannot be reliably priced due to lack of information may carry increased credit risks.

Operating Performance

The current absence of global guidance for the insurance industry on how to integrate ESG risks into the underwriting process has led to the development of various approaches. A growing number of market participants are implementing exclusion criteria within their underwriting lines thereby eliminating certain "toxic" risks, the most common being controversial weapons, coal-based energy production and extraction, and tar sands. At the same time, ESG risks are being considered in the underwriting process through risk selection, geocoding and other metrics to avoid areas subject to higher climate risk related loss severity. Changes in the insurance portfolio mix may have a material impact on prospective underwriting margins, trends and volatility.

AM Best will also consider in its rating analysis the potential for ESG-related litigation and the impact of social inflation on an insurer's earnings and financial results.

In addition to this, key to the discussion regarding ESG integration is determining if there are sustained enhancements to the composition of investment portfolios that ultimately translate into prolonged improvements in the performance of assets held by insurers.

Business Profile

At the same time as insurers are withdrawing from certain types of business not in line with their ESG principles, some opportunities are being recognized such as the development of new products that incorporate social and environmental factors. For life and health writers, this may include products which promote a healthy lifestyle. For P&C insurers, this may be the development of products or solutions to support risks connected with renewable energy. These new products would be viewed within the scope of "Product Risk" as part of the business profile assessment.

Changing demographics offer both challenges and opportunities for insurers. Those who are attuned to customer needs, are innovative and have access to data will be most successful in defending their market position. Alternatively, the business profile assessment may be impacted negatively following an ESG related scandal, which has the potential to materially damage the company's reputation and brand, and could have repercussions on the company's ability to generate new business and retain existing customers.

Insurers obtain a large amount of personal data from policyholders and it is common for insurers to use data to enhance new products and support its efforts to manage risk; however, the usage of personal data also introduces additional risks given the potential for privacy breaches which may also put an insurer's reputation at risk. AM Best will evaluate an insurer's efforts to mitigate issues as it relates to data privacy and security.

Country Risk

AM Best's country risk evaluation entails both a data-driven assessment, which includes ESG factors such as social stability, to score the level of risk in a given country and a qualitative determination of country–specific conditions affecting an insurer's operating environment.

Enterprise Risk Management (ERM)

The "G" in ESG is considered explicitly under the ERM building block for both financial and non-financial factors. Governance and Risk Culture is a key component within the Framework evaluation review components. AM Best's evaluation of an insurer's risk management system framework takes a holistic view of the insurer's risk management system and its associated strategies, processes, tools and owners. AM Best expects that (re)insurers that exhibit strong corporate governance practices in general will likely be able to better manage their risks and opportunities, and will be more likely to experience less volatility in its results over the longer term.

The "E" in ESG is also factored into the ERM assessment as the quality of an insurer's catastrophe stress testing program influences the enterprise risk management assessment. What-if scenario testing using severe events in areas with concentrated exposures is crucial to understanding maximum

potential loss and managing catastrophe risk. Companies also need to consider potential un-modeled scenarios in addition to model output to ensure that they are not overexposed to unforeseen events.

AM Best will also consider the progress of stress testing within the market, and any stress test deficiencies that may result in stress test failure as it regards weather-related risks, such as unmodelled risks and lack of data quality due to climate risk. AM Best will seek to understand how climate risk is factored into the pricing and modelling of risks, in addition to any scenarios related to stranded asset modelling.

ESG integration can also reduce reputational and operational risks as ESG can assist companies to identify risks or opportunities that may not be captured by conventional financial metrics. Given ESG's potential financial impact, the practice of quantifying and integrating climate risks into risk management and underwriting is also likely to grow in importance.

B. Balance Sheet Strength

Rating Unit Review Components

BCAR	Quality of Capital
Stress Tests	Quality of Reinsurance
Liquidity	Reinsurance Dependence
Asset Liability Management	Appropriateness of Reinsurance Program
Internal Capital Models	Fungibility of Capital

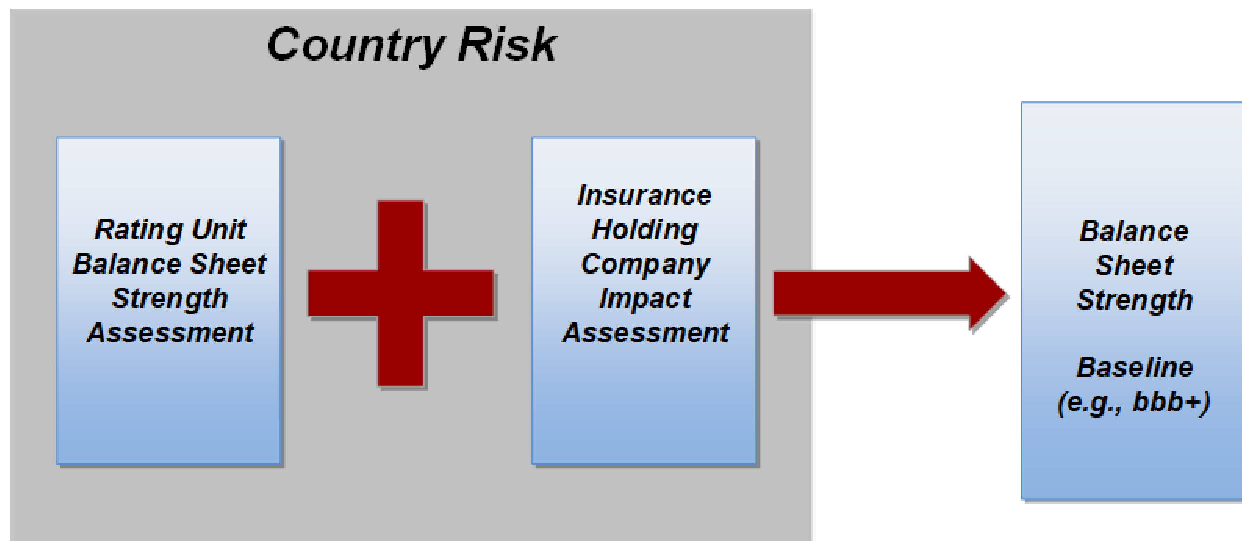
Insurance Holding Company Review Components

Consolidated BCAR	Operating Leverage
Financial Flexibility/Liquidity	Financial Leverage
Coverage	Intangible Assets

Introduction

Balance sheet strength is the foundation for financial security and is critical in determining a company's ability to meet its current and future financial obligations. The assessment of balance sheet strength is threefold and consists of a rating unit analysis, insurance holding company impact assessment, and country risk evaluation (**Exhibit B.1**).

Exhibit B.1: Steps to Completing the Assessment of Balance Sheet Strength



The process begins with a review of risks at the rating unit level. This analysis includes an evaluation of underwriting, credit, interest rate, market, and other risks to gain a broad understanding of their potential impact on the rating unit's current and future balance sheet strength. Next, risks that pertain to the IHC/parent company are assessed. AM Best believes that the strength or weakness of an IHC directly affects the financial strength of the lead rating unit and, ultimately, all operating companies. In this analytical approach, the activities of the IHC will directly affect the assessment of the lead rating unit only. This lead rating unit analysis factors in the strengths and weaknesses of both the insurance entities and the IHC or non-insurance affiliates.

The IHC's activities that have an impact on the rating unit include the potential strain of debt-servicing requirements related to the parent's borrowings, as well as benefits derived from potential earnings diversification and financial flexibility. For non-rated subsidiaries, AM Best reviews their risk profiles and the resulting effect on the lead rating unit, including exposure to debt or other borrowings at the IHC. The fungibility of capital—that is, an organization's ability to allocate and deploy capital as efficiently as possible—may be considered part of this impact assessment. The demonstrated willingness and ability to move capital may be viewed positively as an offset to lower capital measures at the rating unit level, subject to regulatory restrictions.

The assessment of balance sheet strength includes an analysis of an organization's financial statements at the rating unit, IHC, and/or consolidated level (when available). AM Best's analytical process incorporates a host of quantitative and qualitative measures that evaluate the financial strength and financial flexibility of a rated entity; some of the elements reviewed include corporate capital structure, financial leverage, interest expense coverage, cash coverage, liquidity, capital generation, and historical and prospective sources and uses of capital.

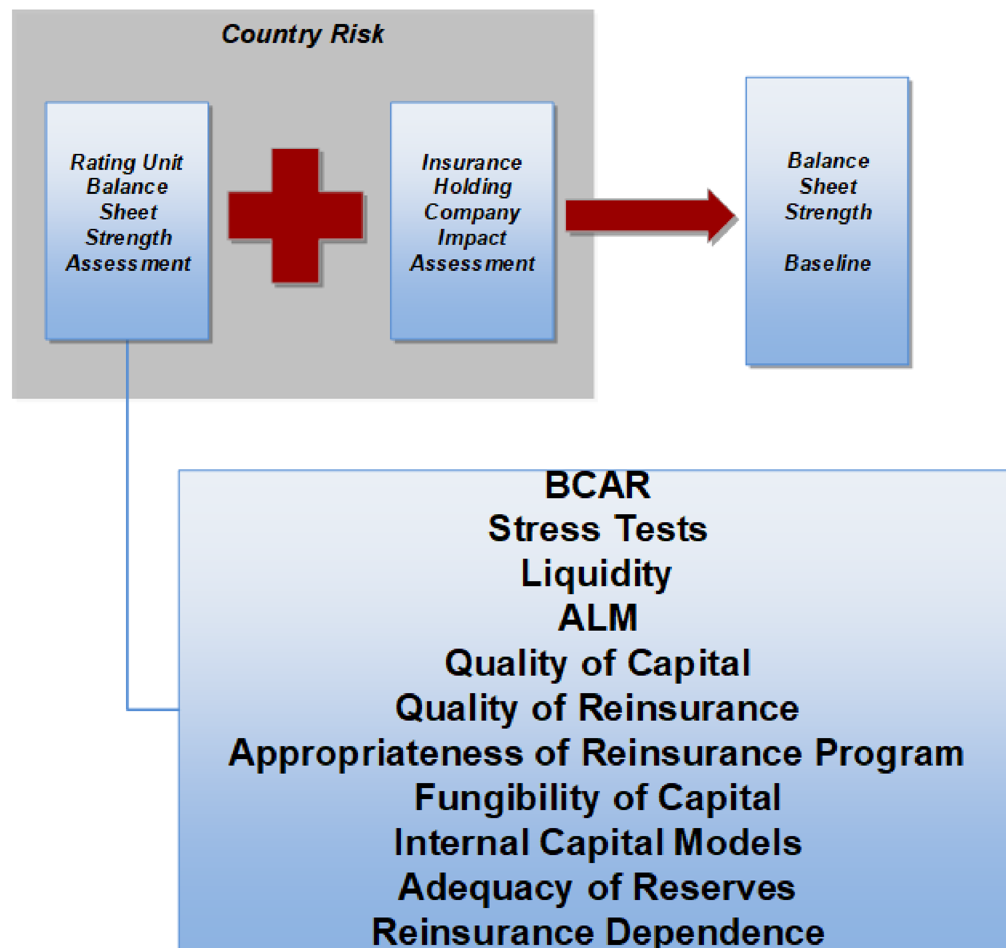
Finally, an assessment of the country risk impact (if any) on the rating unit's balance sheet will be determined. AM Best identifies the various factors in a country that may directly or indirectly affect an insurance company. For companies operating and domiciled in CRT-1 and CRT-2 countries, no additional impact is anticipated. For CRT-3 to CRT-5 countries, the inherent volatility in these jurisdictions will limit the level of the initial balance sheet assessment, given the increased probability that external factors will affect the company's ability to fulfill policyholder obligations.

The overall analytical process allows for flexibility depending on jurisdiction and availability of financial data. In some cases, greater analytical weighting may be given to consolidated capitalization, relative to the rating unit view, effectively combining elements of the rating unit and IHC assessments. The impact of country risk is then incorporated into the final balance sheet assessment.

Rating Unit Review

Key to the balance sheet assessment is the measurement of capital adequacy. When assessing the capital adequacy of a rating unit, AM Best uses several tools: BCAR, its own proprietary capital model; various regulatory capital measures; an entity's internal (economic capital) models; and additional analytical factors. **Exhibit B.2** details some of the factors considered in the review.

Exhibit B.2: Rating Unit Review



Best's Capital Adequacy Ratio (BCAR)

The primary quantitative tool used to evaluate a rating unit's balance sheet strength is BCAR, which helps differentiate an insurer's balance sheet strength and determine whether its capitalization is appropriate. However, it is important to note that the BCAR itself is not directly tied to a rating outcome. **Exhibit B.3** shows the formula used to calculate BCAR.

Exhibit B.3: BCAR

$$\text{BCAR} = \left(\frac{\text{Available Capital} - \text{Net Required Capital}}{\text{Available Capital}}\right) \times 100$$

Rating analysts will typically run two BCARs, one at a rating unit level and one at the IHC/consolidated level. The timeliness and precision of detailed data available will determine which

method receives greater weighting in the analysis. AM Best may review the enterprise's consolidated capitalization and leverage as part of the assessment.

AM Best evaluates an insurer's underwriting, financial, and asset leverage individually; these areas are also evaluated collectively with BCAR. The net required capital to support the financial risks associated with the exposure of an insurer's assets and underwriting to adverse economic and market conditions is compared with available capital. This permits a more discerning view of an insurer's balance sheet strength relative to its operating risks.

Application of BCAR

Exhibit B.4 provides a reasonable guide for the BCAR levels needed to support consideration for a particular BCAR assessment. This assessment takes place prior to other considerations such as quality of capital, IHC impact, and country risk. The BCAR assessments can vary from "Very Weak" to "Strongest" and are determined by comparing the rating unit's BCAR from each specified confidence level to the corresponding guideline associated with the assessment. The highest assessment—in which the rating unit's corresponding BCAR still exceeds the stated guideline—yields an initial BCAR assessment, which will be considered in light of the other balance sheet strength components (including stress testing). However, the BCAR score itself is not the sole determinant of the balance sheet assessment, and rating analyst interpretation of elements leading to the BCAR score may not result in a direct alignment of the score with the BCAR assessment noted in **Exhibit B.4**.

Exhibit B.4: BCAR Assessments

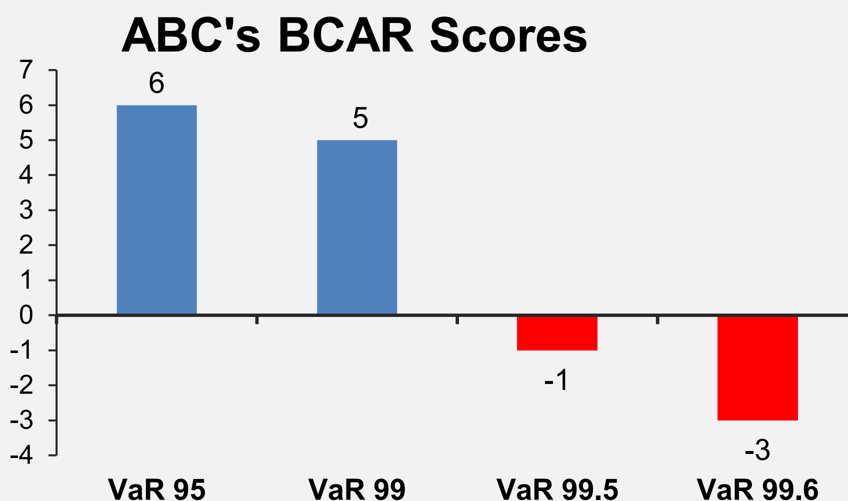
VaR Confidence Level (%)	BCAR	BCAR Assessment
99.6	> 25 at 99.6	Strongest
99.6	> 10 at 99.6 & ≤ 25 at 99.6	Very Strong
99.5	> 0 at 99.5 & ≤ 10 at 99.6	Strong
99	> 0 at 99 & ≤ 0 at 99.5	Adequate
95	> 0 at 95 & ≤ 0 at 99	Weak
95	≤ 0 at 95	Very Weak

The BCAR assessments labeled "Weak," "Adequate," and "Strong" would mandate a BCAR higher than zero at the corresponding confidence levels of 95.0%, 99.0% and 99.5%. The BCAR assessments labeled "Very Strong" and "Strongest" both use the rating unit's BCAR at the 99.6% confidence level. However, to be considered for "Very Strong," the rating unit's BCAR at the 99.6% confidence level would need to be higher than 10; to be considered "Strongest," the rating unit's BCAR at the 99.6% confidence level would need to be higher than 25.

The higher BCAR guidelines used at the 99.6% confidence level are needed to capture tail risk in a more equitable manner, given that consistent and reliable modeled output for natural and man-made catastrophes—as well as economic scenarios—is not available on a global basis.

Exhibit B.5: BCAR Application for ABC

ABC's BCAR scores were positive at VaR 99 and negative at VaR 99.5. The size of the drop-off between its last positive score (5) and its first negative one (-1) was relatively small; the slope of its score decrease is also more gradual. After reviewing ABC's history, the analyst has determined that these BCAR scores are consistent with ABC's previous performance, demonstrating stability. ABC has an implied BCAR assessment of "Adequate".



ABC's BCAR scores imply an assessment of "Adequate"; however, the rating unit level review of balance sheet strength is not complete. It continues with an evaluation of some (or all) of the analytical factors in the graphic below.

BCAR
Stress Tests
Liquidity
ALM
Quality of Capital
Quality of Reinsurance
Appropriateness of Reinsurance Program
Fungibility of Capital
Internal Capital Models
Adequacy of Reserves
Reinsurance Dependence

Additional Analytical Factors

The rating unit balance sheet strength assessment is not solely determined by the quantitative components of BCAR. After reviewing the BCAR output, a rating analyst will also consider other factors, such as the following:

- Quality and appropriateness of reinsurance programs
- Quality and diversification of assets
- Adequacy of reserves
- Financial and operating leverage
- Liquidity
- Quality of capital
- Internal economic capital models

Quality and Appropriateness of Reinsurance Programs

Reinsurance plays an essential role in the risk-spreading process and provides insurers with varying degrees of financial stability. A reinsurance program should be appropriate relative to its risk appetite, underwriting risks, and catastrophic exposures. In addition, a reinsurance program should be diversified and include reinsurers of good credit quality since, in the event of a reinsurer's failure to respond to its share of a loss, the insurer would have to absorb a potentially large loss in its entirety.

To be considered adequate for catastrophic protection, a program needs to protect a company from an impairment or insolvency caused by large shock losses from natural or man-made catastrophes. For those insurers exposed to a series of smaller natural disaster related losses that do not trigger recovery from a traditional catastrophe reinsurance program, an aggregate catastrophe cover may be needed. Beyond spreading risk, reinsurance can help a company write more business than would otherwise be possible by allowing the company to leverage its surplus. Insurers may also mitigate their risk through the issuance of catastrophe bonds or the use of sidecars.

Insurers relying on reinsurance protection to provide coverage against losses in higher return periods are viewed less favorably than those choosing to hold capital to protect against those same losses, all else being equal. AM Best considers companies with excessive reliance on reinsurance as a form of capital to be exposed to pricing fluctuations and availability in the excess reinsurance market. With reference to capital and earnings, these companies are typically more volatile than those that rely mainly on holding capital to protect against losses in higher-return periods. As such, AM Best may use the ceded probable maximum loss (PML)—represented by the ratio of ceded pre-tax net PML relative to surplus—to evaluate a company's reliance on reinsurance. The balance sheet strength assessment of companies with a ceded PML over an acceptable level will be adjusted downward.

A reliable reinsurance program must provide the company with protection against adverse fluctuations in experience. The extent of reinsurance use must be evaluated with the ability to manage growth relative to demands for insurance coverage in existing economic and regulatory environments.

An insurer's ability to meet its financial obligations can become overly dependent on the performance of its reinsurers. A rating unit can also become exposed to the state of reinsurance markets in general. A significant dependency on reinsurance can become problematic if a major reinsurer of the rating unit becomes insolvent or disputes coverage for claims. Issues can also arise if general reinsurance rates, capacity, and terms and conditions change dramatically after an industry event. The greater a rating unit's dependence on reinsurance, the more vulnerable its underwriting capacity becomes to adverse changes in the reinsurance market. The greater the dependency, the greater AM Best's scrutiny of the unit's reinsurance program to determine its appropriateness, credit quality, and permanency, as the risk of overdependence on reinsurance may be similar to that of short-term debt. Reinsurer concentration can be problematic for many of the same reasons as reinsurance dependency; a rating unit with a concentration of recoverables ceded to a small number of reinsurers would have significant issues in instances of reinsurer insolvency. As such, AM Best may qualitatively incorporate an assessment of a rating unit's concentration risk into the balance sheet strength assessment.

Quality and Diversification of Assets

The quality and diversification of assets contributes to a rating unit's financial stability. Invested assets are evaluated to gauge the risk of default and the potential impact on surplus if these assets are unexpectedly sold. The higher the liquidity, diversification, and/or quality of the asset portfolio, the lower the uncertainty inherent in the value to be realized upon the sale of an asset, and thus the lower the likelihood of default. Asset/liability management and duration-matching are key areas of focus for this portion of the analysis.

Investment guidelines are reviewed to identify any lack of diversification among industries or geographic regions, with particular attention paid to any investments exceeding 10% of a rating unit's capital. Companies holding illiquid, undiversified, and/or speculative assets and significantly exposed to volatile lines of business that are vulnerable to unfavorable changes in underwriting and/or economic conditions can jeopardize policyholders' surplus. Thus, AM Best may review a rating unit's exposure to risky assets relative to surplus.

The rating unit's investment management capabilities, its performance, and the resulting impact on capital may also be evaluated. Companies should be able to explain the risks that they choose to avoid, keep, or hedge, including those taken in the investment portfolio.

Adequacy of Reserves

Reserves play an important role in determining the balance sheet strength and flexibility of an insurance carrier, as well as its underlying profitability. The estimation of ultimate reserve requirements is subject to uncertainty. Actuaries who certify a company's reserves typically provide management with a range within which loss and loss-adjustment expense reserves are deemed adequate. The range of reserve adequacy estimated by actuaries can be very significant. For certain business lines, a relatively small deficiency in current reserves may have a significant impact on policyholders' surplus and, therefore, weaken its financial position.

AM Best will assess that sufficient reserves are held to ensure that reserves are maintained at an appropriate level to reduce the possibility of a shortfall. Favorable overall loss reserve development trends with a stable approach to establishing reserves for claims is viewed more favorably.

Financial and Operating Leverage

As part of forming an overall opinion of balance sheet strength, AM Best evaluates a rating unit's total leverage, which includes financial and operating leverage. Financial leverage, through debt or debt-like instruments, may place a call on earnings and strain an insurer's cash flow. Operating leverage is broadly defined as leverage used to fund a specific pool of matched assets. Regardless of its form, excessive leverage may affect an insurer's liquidity, cash flow, and operating profile and could lead to financial instability, particularly during times of systemic stress in capital markets. This evaluation can impact the initial balance sheet assessment.

High financial leverage may lead to financial instability. As such, an analysis of financial leverage in the capital structure is conducted at both the rating unit level and, if applicable, at the IHC level, which allows AM Best to determine if both balance sheets are sound and unencumbered. Crucial to an insurer's balance sheet assessment is the ability to meet the debt service and other obligations associated with its capital structure.

While AM Best reviews a company's operating leverage at the consolidated (IHC) level, it may also review this exposure at the rating unit level. Debt obligations viewed by AM Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, subject to published thresholds.

Liquidity

Liquidity measures an insurer's ability to meet anticipated short- and long-term obligations to policyholders and other creditors. Liquidity depends on the degree to which financial obligations can be satisfied, whether by holding cash and investments that are sound, diversified, and liquid, or through operating cash flow. A high degree of liquidity helps an insurer meet unexpected cash needs without the untimely sale of investments or fixed assets, which could result in substantial realized losses due to temporary market conditions and/or tax consequences.

AM Best's liquidity analysis includes a holistic and comprehensive approach that examines liquidity at the rating unit and IHC/consolidated level. Operational and net cash flows are reviewed—since they can meet some liquidity needs—provided that cash flows are positive, large, and stable relative to cash requirements. A review of liquidity resources (sources and uses) at the IHC is also undertaken, as the insurance companies are often the primary sources for debt servicing. Liquidity triggers, such as material adverse change clauses, covenants, or other restrictions, or demands for additional collateral through collateral calls, are examples of features typically examined. AM Best also monitors access to the capital markets and back-up lines of credit.

Discussions with management to consider how a company would react in a stress scenario of immediate and material cash demands may be part of this analysis. For US life insurers, AM Best's

Stress Liquidity Ratio is calculated using statutory data to measure short-term (30 days) and longer-term (6 to 12 months) cash needs in stress scenarios. Finally, AM Best may evaluate the quality, market value, and diversification of assets, particularly the exposure of large single investments relative to capital.

Quality of Capital

In addition to leverage, AM Best considers the quality of the rating unit's capital structure and the permanency of its capital. As part of its quality of capital analysis, AM Best typically reviews the terms and conditions of securities issued; the maturity schedule of the capital structure; and the level of goodwill, the net economic value of long-term business, deferred acquisition costs, and other intangible assets relative to reported equity and total capitalization. A rating unit may have a strong regulatory capital position, but the quality of its capital and/or that of its IHC may be poor (e.g., highly leveraged, with weak coverage and poorly laddered maturities). In this instance, a lower assessment for balance sheet strength would result.

The level of intangible assets is of particular importance when such items constitute a significant portion of an organization's capital base, thus distorting its financial leverage ratios compared with its peers. Elevated levels of intangibles may be indicative of a rapid growth strategy and subject the company to impairments that may lower reported equity levels.

Another measure used to assess capitalization is double leverage, i.e., the ratio of an IHC's investments in subsidiaries to its adjusted equity. Double leverage is used to determine the extent to which debt issued at the IHC is contributed as equity to one or more operating companies. High double leverage without any mitigating factors can lead to an unfavorable view of the quality of the organization's capital.

Finally, AM Best will review the absolute level of capital available in the rating unit. Data from its impairment studies reveal a direct relationship between surplus size and financial impairment. As a result, typically rating units reporting surplus levels of USD 20 million or less would be ineligible for rating unit balance sheet assessments of "Strongest" prior to the impact of the IHC assessment (for lead rating units). A rating unit would need to report at least USD 20 million in surplus for three consecutive years to be considered for the highest assessment. In addition, the characteristics of certain rating units, primarily heightened uncertainty about future balance sheet conditions, would likely preclude assessments of "Strongest." These include rating units with fewer than five years of operating experience or limited execution of a business plan to date, as well as run-off companies.

Internal Economic Capital Models

Many large, sophisticated insurance groups use their own internal models as part of their risk assessment process. One of the tools often used to quantify risks and measure the volatility and correlation of risks is an internal economic capital (IEC) model. Insurers that decide to invest in the development of an internal economic capital model might reach a better understanding of all their risks and how to efficiently shift their strategy when market conditions change. AM Best believes that

a strong IEC model can be valuable to an insurer when used as one of many tools and processes within the overall risk management framework.

When evaluating balance sheet strength, AM Best may review the level of reported capital relative to an insurer's calculated required economic capital. The required capital provided by a company should be from well-understood, proven IEC models that capture the enterprise's material risks. The IEC model must be tested and run frequently and have the capability to create short-, medium- and long-term time horizons for several risk/return measures. The IEC model should be able to identify scenarios in which individual risks provide natural hedges to mitigate overall exposure, as well as risks that can compound overall exposure. Additionally, a strong IEC model typically captures the material risks associated with each of the major categories of risk, i.e., credit risk, market risk, underwriting risk, operational risk, and strategic risk.

AM Best may give consideration to company-run IEC models in conjunction with a rating unit's reported BCAR score, which in turn could lead to a change in the balance sheet strength assessment. The primary advantage of a strong internal capital model is the benefit it provides company management in understanding and quantifying key risks and their correlations from a holistic viewpoint. AM Best would expect company management to discuss the key risks to capital in their models.

Management also must demonstrate that it can explain the model and its output, as well as potential model risks and limitations. Members of management should be ready to show how the model helps them understand the volatility of their risks, the underlying correlations of those risks, and the drivers of the volatility. The weight given to IEC model results in the overall balance sheet strength assessment will be determined by the rated entity's ability to explain the key drivers of any material discrepancies when compared to the BCAR.

AM Best expects companies to analyze actual results in the context of risk tolerance and key metrics. Eventually, as actual results are compared with expected results, the model will develop a track record as a dynamic management tool that will either prove or disprove its value to the company. This information and analysis may be reviewed and discussed at the company rating meetings and incorporated into the determination of capital requirements and the assessment of balance sheet strength.

Rating Unit Assessment

After considering all of the analytical factors relevant to the rating unit evaluation, the rating analyst will arrive at an assessment for the rating unit's balance sheet strength (**Exhibit B.6**). This assessment can range from "Strongest" to "Very Weak." After arriving at this assessment, the rating analyst will proceed to an evaluation of the IHC if the rating unit is the lead rating unit. The IHC review is not part of the balance sheet strength assessment process for non-lead rating units or lead rating units with non-insurance parents.

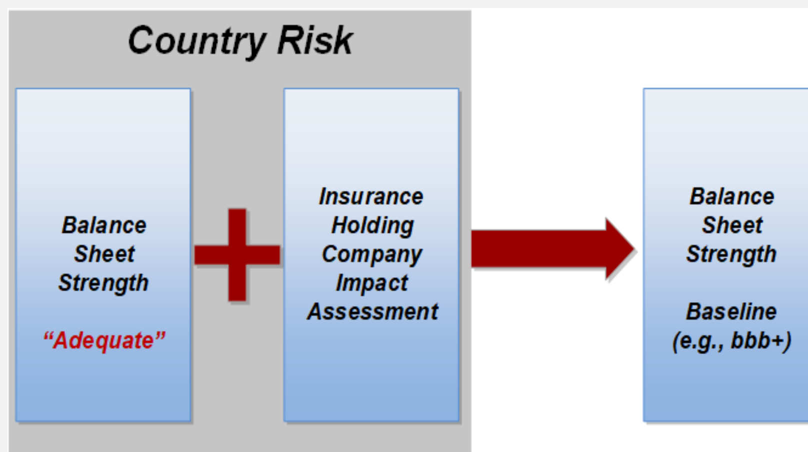
Exhibit B.6: Balance Sheet Strength Assessment of the Rating Unit

Assessment	Key Characteristics
Strongest	The rating unit has the strongest BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also the strongest. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of strongest.
Very Strong	The rating unit has a very strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also very strong. It has an appropriate and diverse reinsurance program. Any additional analytical factors are in line with an assessment of very strong.
Strong	The rating unit has a strong BCAR score with a demonstrated pattern of stability. Its quality of capital and ALM are also strong. It has an appropriate and diverse reinsurance program. Any additional factors are in line with an assessment of strong.
Adequate	The rating unit has an adequate BCAR score that has been relatively stable. Its quality of capital and ALM are adequate. It has an appropriate reinsurance program. Any additional factors are in line with an assessment of adequate.
Weak	The rating unit has a weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are weak. Its reinsurance program is weak. Any additional factors are in line with an assessment of weak.
Very Weak	The rating unit has a very weak BCAR score with a demonstrated pattern of volatility. Its quality of capital and ALM are very weak. Its reinsurance program is very weak. Any additional factors are in line with an assessment of very weak.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive

Exhibit B.7: Example of a Rating Unit's Balance Sheet Strength Assessment for ABC

ABC's BCAR scores implied an assessment of "Adequate". A review of additional analytical factors—such as ABC's quality of capital, ALM, and reinsurance program—also supports an assessment of "Adequate". Thus, ABC's rating unit's balance sheet strength is assessed as "Adequate".



Insurance Holding Company Review

If the analysis is not performed at the consolidated level, consideration for IHC impact is the next step in the baseline assessment of the overall balance sheet strength of lead rating units. As previously mentioned, some of the benefits of IHCs are their ability to provide the lead rating unit with a degree of financial flexibility via capital infusions, access to capital markets, and, in some cases, additional cash flow from other unregulated operations. Likewise, debt and other securities are typically obligations of an IHC and can—depending on the magnitude of these obligations—diminish the financial flexibility of the enterprise, potentially strain future earnings, and inhibit growth in surplus at the insurance company level.

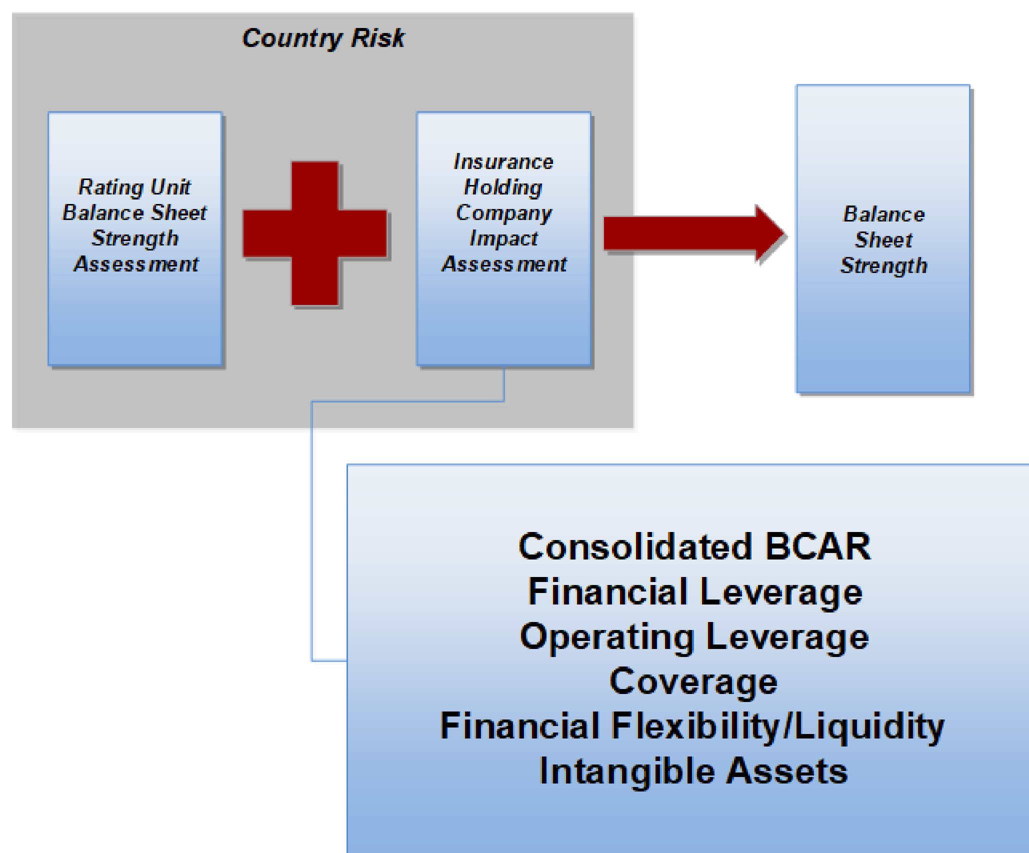
The lead rating unit's balance sheet strength assessment incorporates an evaluation of material risks, including the exposure to risk generated by activities at the parent/IHC and non-rated affiliates. Understanding the potential effect of the activities of the ultimate parent/IHC is integral to developing a comprehensive view of the lead rating unit's risk profile. As a result, all ultimate parents are reviewed and analyzed to determine, at a minimum, whether the parent's activities could reasonably be expected to place a call on the capital of the lead rating unit, or expose the lead rating unit to material risk—even if no public rating is assigned to the parent.

The intent of the review is to capture the entire group's financial performance, capital position, financial leverage, fixed-charge coverage, liquidity, asset quality and diversification, and other factors to ensure that the organization as a whole is in good financial standing. When the lead rating unit is

both the operating company and the IHC, the IHC assessment will be "neutral," as leverage, coverage, and access to capital are factored into the lead rating unit analysis. Also, when the parent is not primarily engaged in insurance activities, the IHC analysis is assessed in "Lift/Drag" so there is no assessment in this building block.

As part of its analysis of balance sheet strength, AM Best may calculate a consolidated BCAR using the consolidated financial statements of the IHC, or of the operating insurance parent company if no IHC exists. As it does for the operating company, the BCAR model produces an absolute score on a consolidated basis, which is the difference between the insurer's available capital and the insurer's net required capital taken as a ratio to its available capital, at each confidence level. **Exhibit B.8** details some of the analytical factors that may be considered when reviewing the impact of the IHC on the lead rating unit.

Exhibit B.8: Insurance Holding Company Review



Financial Leverage

Borrowing at either the operating or IHC level changes an insurer's risk profile. To evaluate the level of debt in the capital structure, AM Best uses several financial leverage ratios that compare the level of debt to the level of capital. Accordingly, AM Best has developed guidelines for gauging the impact

of borrowing levels and servicing ability. This analysis is part of the review of balance sheet strength, regardless of whether the insurer issues public debt.

For complex organizations with multiple operating subsidiaries below an IHC, the rating analyst will use analytical judgment to determine the extent to which each rating unit or non-insurance affiliate is, in practice, supporting the borrowing and, as a result, the levels of leverage relevant to each rating unit.

Typical Financial Leverage Ratios

Financial Leverage (Unadjusted): This ratio compares debt to capital before adjustments made to equity credit for hybrid securities.

Financial Leverage (Adjusted): This ratio compares debt to capital after adjustments made to equity credit for hybrid securities.

Debt to Tangible Capital: This ratio compares debt to capital, but adjusts capital by subtracting intangible assets such as goodwill.

Operating Leverage

To supplement its assessment of financial leverage, AM Best also reviews a company's operating leverage at the consolidated IHC level. AM Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the likelihood of a call on an insurer's earnings and cash flow. Debt obligations viewed by AM Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

Coverage

In evaluating an IHC's ability to service its financial obligations, AM Best considers several coverage ratios, including interest and fixed-charge coverage. The ability to service financial obligations over time is a function of the organization's current capitalization and its capacity for generating earnings from operations. Unencumbered cash, cash equivalents, and short-term investments held at the IHC may also support the parent company's debt service and other short-term obligations. Management's track record of share repurchases and shareholder dividends is considered in the assessment of the IHC's prospective creditworthiness and expected coverage ratios.

Coverage Ratios

Interest Coverage: This ratio compares operating earnings before interest and taxes (EBIT) to interest expense plus non-equity preferred stock.

Fixed-Charge Coverage: This ratio compares operating EBIT to adjusted fixed charges. The rating analyst may review this ratio if it differs significantly from interest coverage and there are concerns about the rating unit's ability to pay its fixed obligations.

Financial Flexibility/Liquidity

An IHC's liquidity depends on the degree to which it can satisfy its financial obligations through operating cash flow or by holding cash and investments that are sound, diversified, and liquid. An IHC with undiversified operations relies primarily on the dividend-paying capacity of its insurance subsidiaries for its cash flow. Dividend capacity, in turn, is contingent in part on the organizational structure. The presence of profitable, non-regulated subsidiaries is viewed as a positive, since there are generally no limitations on the amount of dividends that they may upstream. Additional sources of cash, including bank credit facilities, also can enhance liquidity. Insurance holding companies with a good liquidity profile are typically viewed more favorably due to their seemingly stronger financial flexibility. Diverse funding sources, including assets identified as cash equivalents, can help IHCs 1) fund working capital needs, 2) meet short-term debt obligations of both principal and interest expenses, and 3) potentially return cash to shareholders in the form of cash dividends and/or share repurchases. Both the various sources and the IHC's proven ability to maintain liquidity, in addition to the current absolute level of liquidity an IHC maintains, are reviewed.

AM Best's analysis of overall IHC liquidity risk may incorporate the IHC's near-term claims on cash, both direct and contingent, a quantitative and qualitative review of the IHC's sources and uses of liquidity, market conditions, and contingency plans. The ability to generate immediate and near-term cash flow can vary significantly among IHCs.

Properly understanding relevant issues, such as an IHC's short-term funding risk and debt-service requirements, often involves an in-depth dialogue between AM Best's analytical team and the company's senior management. This analysis generally focuses on the typical sources and uses of cash at the IHC level. Still other IHCs may have alternative liquidity sources, spreading dividends among subsidiaries with, and without, restrictions on dividends paid. To assess the overall strength or weakness of an entity's liquidity, an IHC's projected sources and uses over the next 12+ months may be evaluated.

Analysis of Sources and Uses

Insurance holding companies generally issue both short- and long-term financing instruments. In evaluating an IHC's liquidity risk, AM Best considers the IHC's potential near-term obligations compared to all likely near-term sources of cash. The analysis of an issuer's short-term creditworthiness begins with a careful assessment of its liability structure, including its maturing obligations over the short term; the maturity profile/liquidity of any invested assets held at the issuer level; and the exposure of the assets and liabilities to market risk. The purpose of the assessment is to identify the magnitude of short-term funding, any maturing long-term funding used in the capital structure, and any other potential short-term obligations that the IHC's alternative liquidity arrangements may be required to fund. Outstanding commercial paper is a component of near-term obligations, while bank credit facilities often are viewed as a component of the potential near-term sources of cash until drawn.

Financial Flexibility/Access to Capital

A primary concern for an insurance organization is its need to maintain an amount of capital commensurate with its risk profile. Although insurers have access to a variety of mechanisms to fund ongoing operations, conduct M&A, or manage risk, their ability to access capital in times of stress may be limited. Thus, a demonstrated ability to access capital markets at a reasonable cost is a positive rating factor. Rating analysts may discuss with insurance company management plans for access to capital in a variety of scenarios.

Asset Allocation/Investment Risk

The quality and diversification of assets contribute to a company's financial stability. Invested assets (principally bonds, common stocks, mortgages, and real estate) are evaluated to assess the risk of default and the potential impact on an IHC's capital if the market value of these assets declines unexpectedly. The higher the liquidity, diversification, and/or quality of the asset portfolio, the lower the uncertainty in the value to be realized upon an asset sale, and thus the lower the likelihood of default.

Off-Balance-Sheet Risk

Any off-balance-sheet items to which an IHC may be exposed are analyzed to determine the potential effect on the group's financial flexibility, liquidity, surplus, or loss exposure. Examples of these items include balances associated with non-controlled assets, guarantees for affiliates, contingent liabilities, unfunded pension plan obligations, long-term lease obligations, and interest-rate swaps.

Intangible Assets

Intangible assets are reviewed as part of the assessment of the overall organization's quality of capital. The capital of IHCs with significant levels of intangible assets included in the calculation of available capital is viewed as being of lower quality. As these assets have uncertain values over time, and are subject to non-cash impairment, balance sheets may be "inflated" if assumptions are proven to be incorrect or economic conditions change, causing a write-down in the intangible asset. IHCs making significant impairment charges may also lead to a loss of investor confidence, which would make raising capital or refinancing more difficult and expensive.

Non-Rated Affiliates

AM Best reviews non-rated affiliates as part of the assessment of the ultimate parent's activities through the analysis of information—such as the organizational chart and consolidated financials—provided by the rating unit's management. To gain comfort with a group's non-insurance affiliates and determine the strategic fit of these entities, AM Best holds discussions with management. Additionally, AM Best's rating analysts may use public information, third-party analytical studies, industry reports, and their own analysis of management-provided information to assess a non-insurance affiliate's financial condition.

Insurance Holding Company Assessment

After completing the analysis of all quantitative and qualitative metrics, the rating analyst determines the balance sheet strength impact of the IHC on the lead rating unit. In this step, the rating analyst will choose an assessment of positive, neutral, negative, or very negative, as shown in **Exhibit B.9**. The assessment will depend not only on the balance sheet strength features of the IHC, but also on the likelihood of the lead rating unit being affected by it.

Exhibit B.9: Impact of Insurance Holding Company on Balance Sheet Strength Assessment

Assessment	Key Characteristics
Positive	The consolidated BCAR is supportive of or exceeds that of the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are high. Financial leverage is low on both an adjusted and unadjusted basis. Interest coverage is more than adequate.
Neutral	The consolidated BCAR is consistent with the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are adequate. Financial leverage is acceptable on both an adjusted and unadjusted basis. Interest coverage is adequate.
Negative	The consolidated BCAR score is inadequate relative to the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are low. Financial leverage is high on either an adjusted or unadjusted basis. Interest coverage is inadequate.
Very Negative	The consolidated BCAR indicates a poor financial position relative to the rating unit BCAR. Financial flexibility, liquidity, and access to capital markets are very low. Financial leverage is very high on either an adjusted or unadjusted basis. Interest coverage is inadequate.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Exhibit B.10: Example of Insurance Holding Company Assessment for ABC

The analyst evaluates ABC's IHC relative to the benchmark. The final assessment of the IHC considers specific metrics as well as an overall assessment of holding company capital. Although the factors used to evaluate each IHC are static, the weightings for each of these factors may change on a case-by-case basis in order to reflect those factors that will most impact the insurer's future balance sheet strength. For example, one positive factor may outweigh multiple negative factors, or vice versa.

The positive factors for ABC's IHC include solid capitalization, low financial leverage (on both an adjusted and unadjusted basis), and a high interest coverage ratio. ABC's IHC also has consistent cash inflows that exceed cash outflows and its dividend requirements from subsidiaries are not excessively high. The IHC has demonstrated its ability to access the capital markets and obtain same-day funding through bank credit facilities and letters of credit. Other factors, such as asset quality and diversification, fungibility of capital, and off-balance-sheet risk, were viewed as neither negative nor positive.

In this scenario, the most probable assessment for ABC's IHC impact is "Positive".

Lead Rating Unit and Insurance Holding Company Combined Assessment

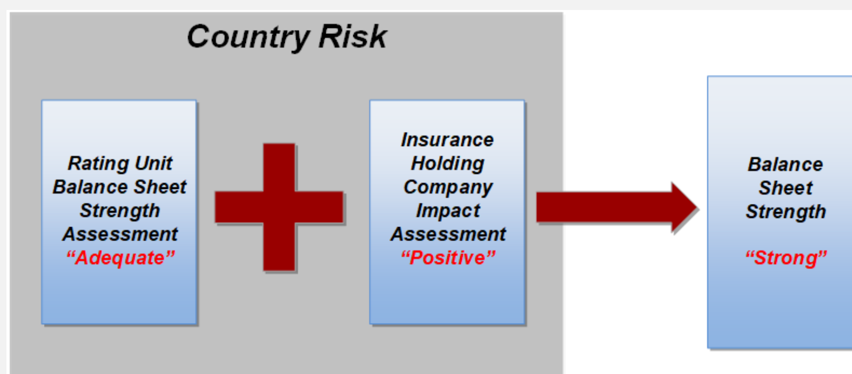
After completing the analysis of the balance sheet strength of both the lead rating unit and the IHC, and using the assessments described in previous sections of this methodology, the analytical team arrives at a combined rating unit/IHC balance sheet strength assessment as described in **Exhibit B.11**.

Exhibit B.11: Combined Balance Sheet Strength Assessment

Lead Rating Unit	Insurance Holding Company: Positive	Neutral	Negative	Very Negative
Strongest	Strongest	Strongest	Very Strong	Adequate
Very Strong	Strongest	Very Strong	Strong	Weak
Strong	Very Strong	Strong	Adequate	Very Weak
Adequate	Strong	Adequate	Weak	Very Weak
Weak	Adequate	Weak	Very Weak	Very Weak
Very Weak	Weak	Very Weak	Very Weak	Very Weak

Exhibit B.12: Example of Combined Balance Sheet Strength Assessment for ABC

ABC's assessment was "Adequate" and its IHC assessment was "Positive". Based on the combination table in **Exhibit B.12**, ABC's combined balance sheet strength assessment is "Strong".



Country Risk Overlay

The final step in the balance sheet strength assessment is the incorporation of country risk. As **Exhibit B.13** shows, the impact of a rating unit's balance sheet strength on the rating recommendation process does have a limit. Balance sheet strength is critical to the evaluation, but a rating is also derived from the assessment of other key factors, namely operating performance, business profile, and ERM, as discussed in the following sections.

For units in CRT-1 and CRT-2 countries, the highest baseline assessment for balance sheet strength is "a+" (**Exhibit B.13**). The "a+" designation is reserved for those rating units which have unquestioned balance sheet strength demonstrated over time.

The lower baseline assessments for CRT-3 through CRT-5 countries reflect the heightened rate at which balance sheet strength can erode in these countries due to country-specific risk factors. AM Best uses a blended CRT for those companies with business operations or exposures in multiple countries with different country risk tiers.

Exhibit B.13: Overall Balance Sheet Strength Assessment

Combined Balance Sheet Assessment (Rating Unit/ Insurance Holding Company)	Country Risk Tier				
	CRT-1	**CRT-2**	**CRT-3**	**CRT-4**	**CRT-5**
Strongest	a+/a	a+/a	a/a-	a-/bbb+	bbb+/bbb
Very Strong	a/a-	a/a-	a-/bbb+	bbb+/bbb	bbb/bbb-
Strong	a-/bbb+	a-/bbb+	bbb+/bbb/bbb-	bbb/bbb-/bb+	bbb-/bb+/bb
Adequate	bbb+/bbb/bbb-	bbb+/bbb/bbb-	bbb-/bb+/bb	bb+/bb/bb-	bb/bb-/b+
Weak	bb+/bb/bb-	bb+/bb/bb-	bb-/b+/b	b+/b/b-	b/b-/ccc+
Very Weak	b+ and below	b+ and below	b- and below	ccc+ and below	ccc and below

Exhibit B.14: Example of Overall Balance Sheet Strength Assessment for ABC

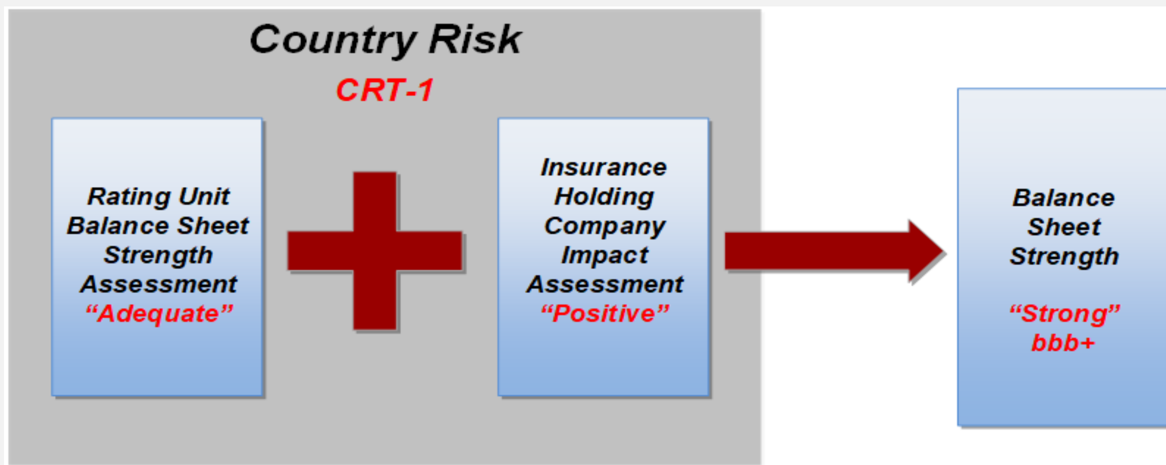
ABC is domiciled in the US, a CRT-1 country. As its combined assessment is "Strong", its baseline can be either a- or bbb+.

Exhibit B.15: Balance Sheet Strength Baseline for ABC

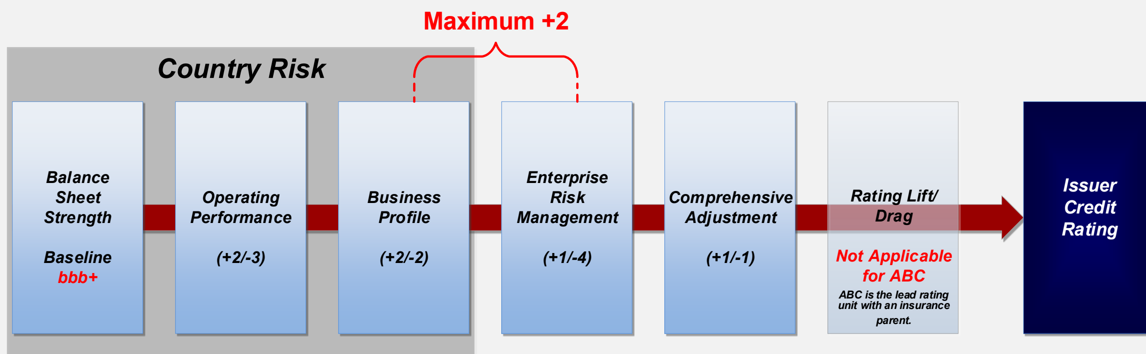
Baseline ("Strong")

In the examples in this section, the implied rating unit balance sheet strength assessment was "Adequate". When factoring in the impact of the IHC ("Positive"), the interim assessment was raised to "Strong". As the rating unit operates and is domiciled in a CRT-1 country, there is no country risk impact.

In this example, the analyst selected the lower of the two applicable baselines. Thus, ABC's baseline assessment for balance sheet strength is "bbb+".



AM Best's Rating Process



C. Operating Performance

Property/Casualty and Health Review Components

Underwriting Performance	*Investment Performance*	*Total Operating Earnings*
Loss Ratio	Net Yield	Pre-Tax Operating ROR
Expense Ratio	Pre-Tax Total Return	Operating ROE
Combined Ratio		
Operating Ratio (P/C Only)		

Life/Health Review Components

Underwriting Performance	*Investment Performance*	*Total Operating Earnings*
Change in NPW & Deposits	Net Yield	NOG to Total Assets
Change in Total Reserves	Pre-Tax Total Return	NOG to Total Revenue
		Operating ROE

Introduction

Profitable insurance operations are essential for a rating unit to operate as a going concern. For most insurers, a consistent stream of earnings is the most dependable source for capital formation. Conversely, insurers whose earnings are weak owing to volatility or operating losses are more likely to struggle to improve, or even maintain, organic capital in the future. AM Best's analysis of operating performance focuses on the stability, diversity, and sustainability of the rating unit's earnings sources and the interplay between earnings and liabilities.

AM Best reviews the components of a rating unit's earnings to evaluate the sources of profits and the degree and trends in profitability. Areas considered include underwriting, investment returns, capital gains/losses, and total operating earnings, both before and after taxes. Profitability measures may be distorted by operational changes; therefore, AM Best examines the business mix and trends in premium volume, investment income, net income, and the resulting impact on surplus. The structure of the rating unit (e.g., stock vs. mutual, profit vs. non-profit), the length and nature of its insurance liability risks, the mix of new vs. renewal business, non-insurance sources of earnings, diversity of earnings, and earnings exposure to economic/regulatory/country risk factors are important for evaluating profitability. The degree of volatility in a rating unit's earnings and the potential impact of this volatility on capitalization and balance sheet strength are of particular interest to AM Best. For example, high inflation, volatile business cycles, and underdeveloped financial markets (which could affect earnings stability) are typical characteristics of higher CRT countries; these factors are reflected in country risk adjustments to the operating performance assessment. Generally, more diversified

earnings streams lead to more stable operating performance. The quality and sustainability of earnings is also evaluated.

AM Best recognizes that a proper assessment of an insurer's current and prospective profitability may involve a review of multiple accounting formats and results to develop an accurate economic picture. AM Best reviews financial statements as well as management reports to understand earnings trends and their ultimate impact on solvency. In many cases, management may focus on measurements beyond the local regulatory reporting basis. For example, to supplement the review of statutory profitability in the US, AM Best may analyze the rating unit's earnings under Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), and any other regulatory or accounting reporting basis available, to better understand the true economics of the business.

Operating Performance Benchmarks

AM Best evaluates the operating performance of each rating unit, understanding that performance metrics are affected by the type of insurance the rating unit writes, as well as the level of risk taken, from both a product and investment perspective. Due to the wide variety of insurance products offered, companies must be analyzed in the context of an appropriate peer group. This analysis includes comparisons against similar companies and composites. To accomplish an appropriate comparison of key operating performance metrics, AM Best calculates benchmark composites. These benchmarks ensure that the operating performance metrics for each insurer are being evaluated in the proper framework.

Benchmarks can be created using industry composites/sub-composites, ICR composites, or other customized parameters. Benchmark composites from a combination of these factors can also be created by the rating analyst.

As part of the benchmarking process, it may be appropriate to compare a rating unit against more than one benchmark. For example, an insurer that offers multiple products may be compared to a number of different industry or country composites or sub-composites. Similarly, evaluating a rating unit's operating performance relative to a composite created from a wide range of ICRs, a customized composite of industry leaders, or direct competitors may be necessary.

When the population of relevant peers is small, the calculation of benchmark composites may be forgone and the operating performance of the rating unit may be evaluated using direct peer comparisons.

The remainder of this section contains a discussion of key operating performance metrics for insurance companies. AM Best understands that different types of insurance organizations will have different benchmarking metrics. For instance, the benchmarked combined ratios of mutual insurance companies will differ from those of stock companies, given that mutual insurance companies include policyholder dividends in their combined ratios.

As part of the rating process, the rating analyst provides commentary on the trends in key ratios, describing any factors that may be affecting the results. The analysis accounts for any volatility due to one-time adjustments and for market conditions that could affect future results.

Analysis of Key Metrics

When evaluating operating performance metrics, the rating analyst will use a variety of quantitative and qualitative measures. In addition to considering the most recent results, the rating analyst may also evaluate historical trends, expected future performance, measures of central tendency, and the volatility of the results. To facilitate peer comparisons, a rating analyst may also use methods of standardization such as calculating the risk-adjusted performance of certain metrics, to properly adjust returns for the degree of risk exposure necessary to generate those returns. When a rating unit has ten years of historical data readily available, the full history may be used by the rating analyst. Typically, more recent results and trends will carry more weight, especially when current growth patterns represent a shift in business strategy and/or an elevated risk appetite. Trend differences between accident year versus calendar year performance will be considered an indication of the quality of earnings and management's reserving and pricing philosophy.

The operating performance metrics in this section are not intended to be all-encompassing and certain industry segments may have results that vary significantly from industry composite results. The rating analyst and the rating committee may choose to use other metrics to assess operating performance results. Additionally, in some instances, the metrics discussed here may not be appropriate for the review of a particular rating unit, due to data limitations or other factors. The review includes the qualitative judgment of the rating analyst, who is expected to select the metrics best suited to the circumstances of the rating unit being evaluated.

Underwriting Performance

The underwriting performance of an insurance rating unit is the profitability of its insurance operations before taking investment performance into account. Generally speaking, low benefit/claim payments and expenses relative to premiums are indicative of strong underwriting performance. In practice, the value of underwriting performance metrics will depend highly on the type of insurance the rating unit writes. Holding all else constant, property/casualty companies that write predominantly long-tailed business (e.g., commercial lines) will likely have higher combined ratios than companies with mostly short-tailed liabilities (e.g., personal lines). However, companies writing long-tailed business have the ability to earn investment income over a longer time horizon, leading to larger increases in profitability over time. Therefore, comparing the underwriting profitability metrics of the rating unit in question to the appropriate benchmark composite is critical. It is also important to understand external factors that may be affecting trends.

Property/Casualty and Health Underwriting Performance Key Metrics

Loss Ratio: This ratio measures the underlying profitability, or loss experience, of the rating unit's total book of business.

Expense Ratio: This ratio measures the operational efficiency in underwriting the book of business. Generally, companies with economies of scale create efficiencies and can keep their operating expenses at lower levels.

Combined Ratio: This ratio measures the overall underwriting profitability after policyholder dividends. A combined ratio of less than 100% indicates the rating unit has an underwriting profit.

Life/Health Change in Premiums and Reserve Key Metrics

Premium growth may be a key driver for future profitability. Careful, tactical growth within stated risk tolerances is viewed very favorably. Low growth, as expressed by a change in net premiums written (NPW) and deposits over a prolonged period, may lead to a weaker earnings profile if the existing infrastructure was built to support a much larger business model and expense gaps persist. It may indicate a loss of brand value or, for health companies, declining membership. It could also be the result of losing key distribution partners. A planned measured reduction in business due to unfavorable market conditions would not be viewed as negatively as these other factors, unless the company is a monoline insurer with limited financial flexibility and modest operating performance.

Conversely, rapid growth may often be a credit negative, especially if weak product design or loose underwriting is driving growth rates at higher than industry levels. Lack of control over distribution, leading to adverse selection, limited internal controls, or oversight may contribute to higher than average growth. Finally, regulatory rate increases may be a driver of premium increases, rather than true organic growth.

A change in reserves correlates to the dynamics of the insurance book of business. Generally, a growing book of business leads to a rising reserve base. However, if in-force business is lapsing or surrendering at a high rate, reserve increases may be muted or negative. Reserve increases may be necessary due to improper pricing or weakened economic conditions relative to initial assumptions. Reserve changes can indicate a changing business mix. Rating analysts may thus look at both the change in NPW and deposits and the change in total reserves in concert to get a more complete picture of emerging trends. The process also includes an understanding of the risks associated with the product that is driving the growth.

Change in NPW and Deposits: This metric measures the year-over-year percentage change in NPW and deposits.

Change in Total Reserves: This metric is the year-over-year percentage change in total reserves, which is calculated using a rolling ten-year historical data period.

Investment Performance

Premiums paid to the insurer are invested to earn a risk-adjusted return consistent with the insurer's investment policy. Net investment income represents a significant portion of an insurer's operating earnings. Given that an insurer's primary investment objective is to fund future policyholder benefits and claims, investment portfolios in the insurance industry are often relatively conservative. Many

insurance companies will seek to minimize their investment portfolios' exposures to interest rate risk, reinvestment risk, liquidity risk, and asset-liability mismatches, while still earning a positive net interest spread; however, the type of business an insurer writes will have a significant impact on its investment strategy. Higher returns are generally preferred and typically indicate strong investment performance, but achieving higher returns is often accompanied by increased risk. A rating analyst may review investment returns in conjunction with an insurer's portfolio allocation to riskier assets as part of their analysis. AM Best monitors all of these risks and analyzes investment performance in the context of both absolute and risk-adjusted returns.

Investment Performance Key Metrics

Net Yield on Invested Assets: This ratio measures the average return on a rating unit's invested assets before capital gains/losses and income taxes. The current yield is the yield as reported on the rating unit's most recent financial statement.

Pre-Tax Total Return on Invested Assets: This metric is calculated using net yield plus realized and unrealized capital gains and losses.

Total Operating Earnings

Total operating earnings metrics are used to evaluate the combined impact of both underwriting and investment performance. Higher returns are preferred to support future operations, but these returns must always be analyzed in the context of the incremental risk taken for them to be achieved. Any significant year-to-year divergence in the operating performance metrics may indicate that the rating unit is taking on more risk. This volatility and increased level of risk may negatively affect AM Best's assessment of operating performance.

Property/Casualty and Health Operating Performance Key Metrics

Pre-Tax ROR (Return on Revenue): This ratio measures a rating unit's operating profitability and is calculated as pretax operating income divided by net premiums earned.

Operating Ratio: This metric measures a rating unit's overall pretax operating profitability from underwriting and investment activities. An operating ratio of less than 100% indicates that a rating unit is able to generate a profit from its core operations.

Operating Return on Policyholder Surplus (PHS) (Return on Equity): This ratio measures a rating unit's efficiency in using its surplus on a total-return basis and is calculated using the overall, after-tax profitability from underwriting and investment activities, including unrealized capital gains.

Life/Health Operating Performance Key Metrics

NOG to Total Assets: This metric is calculated using net operating gain (NOG) (after taxes) as a percentage of the mean of current and prior-year admitted assets. It measures insurance earnings relative to the rating unit's total asset base.

NOG to Total Revenue: This metric is calculated using net operating gain (after taxes) as a percentage of total revenues. This test measures insurance earnings relative to total funds from operations.

Operating Return on Equity: This metric is calculated using net operating gain (after taxes) as a percentage of the mean of current and prior-year capital and surplus. It measures insurance earnings relative to the rating unit's policyholders' surplus base.

Financial Forecasts

Rating analysts may review company-provided forecasts as part of the assessment of operating performance. Understanding the quality and sources of future earnings is vital to determining whether a rating unit can continue to generate a certain level of earnings. Rating analysts may consider historical trends and evaluate the reliability of forecasts. Although historical trends are of value, changing market conditions or sudden shifts in strategy could have a significant and positive or negative impact on operating performance and need to be reflected in the rating evaluation. Rating analysts may use projections, including rating analyst-developed forecasts, to evaluate the impact of future growth plans.

Other Operating Performance Considerations

The operating metrics highlighted in the previous sections as key indicators of financial performance are not meant to be all-inclusive. Additional financial metrics of operating performance unique to lines of business, regions of operation, or corporate structure that are not explicitly mentioned in this document may be used. To gain better clarity and normalize reported results, the rating analyst may also consider other factors (e.g., one-time asset sales, non-recurring litigation expenses, and the impact of hedging). Rating units exhibiting strength or weakness based on other relevant operating performance metrics may be rewarded or penalized on metrics not listed here. Furthermore, a rating analyst may find that some of the listed metrics are not appropriate to the circumstances of a particular rating unit, in which case those metrics would not be part of the evaluation.

Operating Performance Assessment

After completing the analysis of all relevant metrics, the rating analyst assesses the operating performance of the rating unit based on the descriptions shown in **Exhibit C.1**. In practice, most rating units will probably have a mix of both strong and weak metrics; analytical judgment is used to determine which metrics should be assigned more importance. In general, a company performing strongly over time will generate sufficient earnings to maintain prudent capitalization. Strong performers are those whose performance is relatively consistent, with better-than-average earnings and low volatility.

Exhibit C.1: Operating Performance Assessment

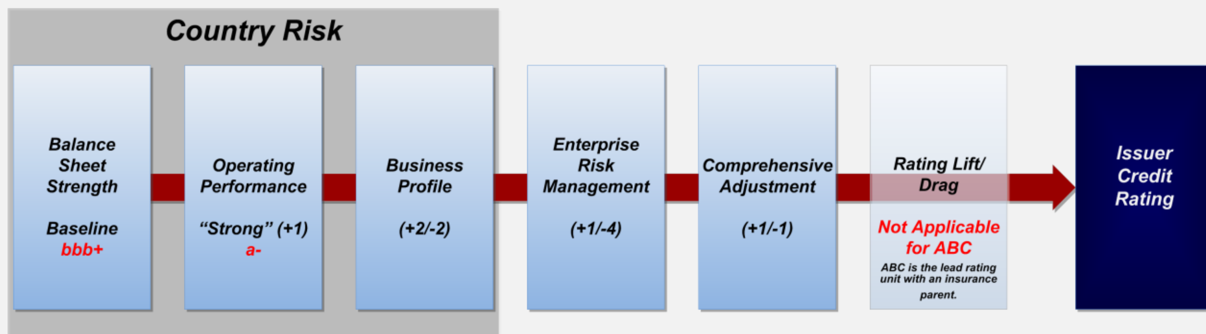
Assessment	Notches	Key Characteristics
Very Strong	+2	Historical operating performance is exceptionally strong and consistent. Trends are positive and prospective operating performance is expected to be exceptionally strong. Volatility of key metrics is low.
Strong	+1	Historical operating performance is strong and consistent. Trends are neutral/slightly positive and prospective operating performance is expected to be strong. Volatility of key metrics is low to moderate.
Adequate	0	Historical operating performance and trends are neutral. Prospective operating performance is expected to be neutral. Volatility of key metrics is moderate.
Marginal	-1	Historical operating trends have been inconsistent. Trends are neutral/slightly negative with some uncertainty in prospective operating performance. Volatility of key metrics is moderate to high.
Weak	-2	Historical operating performance is poor. Trends are slightly negative and prospective operating performance is expected to be poor. Volatility of key metrics is high.
Very Weak	-3	Historical operating performance is very poor. Trends are negative and prospective operating performance is expected to be very poor. Volatility of key metrics is very high.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Exhibit C.2: Operating Performance Assessment for ABC

Strong (+1)

ABC demonstrates strong and consistent underwriting performance when viewed in the context of the benchmark. In addition to a ratio analysis, the rating analyst also performed a separate analysis of historical operating performance trends for ABC. Historical results revealed that ABC has consistently maintained its strong overall operating performance for the last ten years. Although an in-depth analysis of business profile is required to determine if ABC's strong performance will persist, the operating performance results do not reveal any evidence of this trend reversing in the near future. The rating analyst arrives at an operating performance assessment of "Strong" for ABC; its baseline assessment will be adjusted upwards from "bbb+" to "a-".



D. Business Profile

Review Components

Market Position	Pricing Sophistication and Data Quality	Product Risk
Degree of Competition	Management Quality	Regulatory, Event, Market, and Country Risks
Distribution Channels	Product/Geographic Concentration	Innovation

Business profile is a qualitative component of AM Best's rating evaluation that directly affects the quantitative measures. An insurer's business profile affects current and future operating performance and, in turn, its long-term financial strength and the rating unit's ability to meet its obligations to policyholders.

Business profile is influenced by the degree of risk inherent in the rating unit's business mix, competitive market position, and the depth and experience of its management. Limited geographic and/or product line diversification can be negative rating factors, as AM Best believes these issues can have an adverse effect on the rating unit's prospective operating performance and balance sheet strength.

Analysis of an insurer's operating strategy and competitive advantages by line is essential to assess a rating unit's ability to respond to competitive market challenges, potential market disruption, economic volatility, and regulatory changes that could affect its book of business. Defensible and sustainable competitive advantages for a favorable business profile assessment include the following: control over distribution; access to multiple distribution channels to avoid concentration; a low cost structure; effective use and leveraging of innovation; superior service; strong franchise recognition; a captive market of insureds; and underwriting expertise in the book of business. An insurer's market share, country risk, the degree of competition in its market, and the quality of management are also important business profile factors to consider while assessing the sustainability of financial performance.

Market Position

The market position of an insurance rating unit depends largely on what the rating analyst deems the relevant definition of the "market." For example, the market share of a rating unit that writes business in all fifty US states or through much of the European Union may be calculated using a different denominator than the market share for a rating unit that writes business in a single state or country. The size and level of maturity of the main market(s) where the rating unit operates is also factored into the assessment. A sustainable market share is generally viewed more favorably and is often indicative of a defensible competitive advantage (e.g., economies of scale, brand loyalty, longevity in the market). A large market share in unfavorable, volatile, uncertain or loss making markets would not

be viewed as a positive. The rating analyst may also pay special attention to historical increases or decreases in market share and the drivers of these changes.

For insurers that write more than one line of business, multiple market share calculations may be calculated. In this case, an insurer could have a dominant market share for one or more of its products while maintaining a small market share for others. Generally, the higher the percentage of an insurer's total direct premiums written dedicated to a given product line, the more important the market share of that product line is to the overall assessment of the rating unit's market position.

After examining historical market share trends, the rating analyst will then determine an assessment of market position based on **Exhibit D.1**.

Exhibit D.1: Market Position Assessment

Component	Positive	Neutral	Negative
Market Position	Company able to increase profitable market share at a sustainable rate	Company able to sustain profitable market share	Company unable to sustain profitable market share

Degree of Competition

The degree of competition in a particular market can have a significant impact on pricing trends and operating performance results. Although market share can be used as a proxy for the degree of competition in a given market, it can prove misleading. For example, a 50% market share may indicate a very strong competitive position if the market contains many other participants with much smaller market shares, but it could also indicate very intense competition if the market is structured as a duopoly. Therefore, AM Best assesses the degree of competition in a given market by taking into account the market share of all competitors in the industry. Barriers to entry are also factored into the analysis.

Exhibit D.2: Degree of Competition Assessment

Component	Positive	Neutral	Negative
Degree of Competition	Low Competition	Average Competition	High Competition

Distribution Channels

The distribution channels an insurer uses can have a significant impact on a number of variables. For instance, an insurer that chooses to sell its products exclusively online may benefit from cost efficiencies and the ability to reach a different consumer demographic, compared with an insurer that sells exclusively through sales representatives. Insurers that choose to distribute their products through sales representatives must decide whether to use an outside sales force or develop their own in-house

sales team. Outsourcing sales may be more cost-efficient, but could result in lower policy sales due to the outsourced representatives' incentives to also sell competing products. Control over and stability of distribution are other relevant factors, as they can ensure effective sales practices. Concentration in a distribution system is also reviewed, as insurers need to weigh the risk of losing a top producer when choosing to use sales representatives over an automated distribution channel. These are only some of the issues that may arise; rating analysts will consider the implications of an insurer's distribution strategy. **Exhibit D.3** describes the assessments as they pertain to the competitive advantages/disadvantages of a rating unit's distribution strategy.

Exhibit D.3: Distribution Channel Assessment

Component	Positive	Neutral	Negative
Distribution Channel	Company has created a significant competitive advantage through its distribution channels	Company has not created a significant competitive advantage or disadvantage through its distribution channels	Company faces a significant competitive disadvantage with regards to its distribution channels

Pricing Sophistication and Data Quality

Technology plays an increasingly important role as the insurance industry evolves. Companies throughout the industry are making large investments in everything from telematics to data warehouses to artificial intelligence (AI) enabled tools, in an attempt to improve pricing models and better identify and price risks. In some instances, companies have invested heavily in big data initiatives and created senior management positions for chief data officers. Those companies that successfully mine data and leverage new technologies will gain a competitive advantage. To reach one of the assessments shown in **Exhibit D.4**, rating analysts may discuss technology initiatives and the expected competitive advantages with company management.

Exhibit D.4: Pricing Sophistication & Data Quality Assessment

Component	Positive	Neutral	Negative
Pricing Sophistication & Data Quality	Pricing sophistication and modeling capabilities provide a competitive advantage	Pricing sophistication and modeling capabilities provide no competitive advantage/disadvantage	Lack of pricing sophistication and data modeling capabilities result in a competitive disadvantage

Management Quality

The experience and depth of management are important factors for achieving success, because the insurance business is based on a foundation of trust and financial responsibility. Competitive pressures in virtually every insurance market segment have amplified the importance of management's ability to develop and execute defensible strategic plans. Strategies that are well-developed and adaptive to

change are viewed more positively. AM Best's understanding of management's operating objectives plays an important role in its qualitative evaluation of a rating unit's current and future operating performance. This is particularly true when a rating unit is undergoing a restructuring to address operational issues or balance sheet problems, or is actively raising capital. By reviewing the company's public and non-public information and meetings with management, AM Best may assess the strategic initiatives of senior management and determine whether a change in strategy warrants a rating review. Rating analysts may also look for trends in management projections (e.g., if results consistently fall short of annual estimates), turnover, and other areas that could give rise to caution. After evaluating all of these factors, the rating analyst will reach an assessment of management quality described in **Exhibit D.5**.

Exhibit D.5: Management Quality Assessment

Component	Positive	Neutral	Negative
Management Quality	Management is proactive to evolving market conditions and consistently achieves forecasts and targets	Management is reactive to evolving market conditions, occasionally falls short of forecasts and targets	Management is unresponsive to evolving market conditions, provides unreliable forecasts and targets

Product/Geographic Concentration

A rating unit's book of business may be analyzed in terms of both product line and geographic diversification. Companies whose product offerings are well-diversified are often less susceptible to unforeseen risks. For life/health companies, the business mix may be evaluated with respect to the distribution and the balance between investments or protection features, as well as financial guarantees and options. These may be critical in determining the rating unit's sensitivity to economic business cycles or regulatory pressures, such as minimum loss ratios, market conduct regulation, or financial services and health care reform initiatives. For property/casualty companies, the geographic location and concentration of a book of business can have a significant impact on its exposure to catastrophic losses resulting from terrorist attacks, hurricanes, tornadoes, windstorms, hail, or earthquakes, for example. For property insurers, AM Best requires that a rating unit conduct some degree of natural catastrophe modeling on its book of business.

The geographic location and lines of business written by a rating unit also determine its exposure or vulnerability to regulatory or residual market risks in certain jurisdictions. The business mix must be evaluated carefully. Given that underwriting experience varies dramatically among lines of business, a rating unit's underwriting risk profile may be reviewed, since high-risk lines with volatile loss history can affect the financial stability of an insurer, particularly one that is poorly capitalized and/or has poor liquidity. After considering the rating unit's product and geographic concentration, the rating analyst will reach a final assessment of product/geographic concentration (**Exhibit D.6**).

Exhibit D.6: Product/Geographic Concentration Assessment

Component	Positive	Neutral	Negative
Product/Geographic Concentration	Significant diversification of risks across non perfectly correlated product lines and geographies	Moderate diversification of risks across non perfectly correlated product lines and geographies	Limited diversification of risks across non perfectly correlated product lines and geographies

Product Risk

The risk of each of the individual products offered by insurers can also have a strong impact on the business profile assessment. Various risk factors—including the frequency of losses and their severity—influence the analytical evaluation of product risk. **Exhibit D.7** details the general guidelines AM Best uses to evaluate product risk for life and health insurers.

Exhibit D.7: Product Risk Evaluation – Life and Health Insurers

Lower Risk	Medium Risk	Higher Risk
• Current Assumption Universal Life • Group Life • Term Life • Variable Life/Unit-Linked • Whole Life	• Credit Life • Dental • Final Expense/Pre-Need/ Funeral • No-Lapse Universal Life • Stop Loss • Supplemental Accident & Health • Term Universal Life	• Disability Income • Fixed Deferred Annuities • Fixed Indexed Annuities • Immediate Annuities • Individual/Small Group Medical • Large Group Medical • Long-Term Care • Medicare Supplement/Advantage • Structured Settlements • Variable Annuities with Living Benefits

Exhibit D.8 contains a similar guide for property and casualty insurers.

Exhibit D.8: Product Risk Evaluation – Property and Casualty Insurers

Lower Risk	Medium Risk	Higher Risk
• Auto Physical Damage • Boiler & Machinery • Burglary & Theft • Credit (excl. Property) & Credit Accident & Health • Fidelity • Group Accident & Health (Short-Term) • Pet Insurance • Surety • Warranty	• Aviation • Commercial Auto Liability • General Liability Occurrence • Inland Marine • Medical Professional Liability Claims Made • Ocean Marine • Private Passenger Auto Liability • Professional Liability Other Than Medical • Title	• Commercial Multi Peril • Commercial Property • Crop & Crop / Hail • Cyber • Director & Officers • Excess Workers' Comp. • Financial Guarantee • Medical Professional Liability Occurrence • Mortgage Guarantee • Personal Property • Product Liability Claims Made • Product Liability Occurrence • Reinsurance Assumed Non-Proportional Liability • Reinsurance Assumed Non-Proportional Property • Umbrella / Excess • Workers' Comp.

The general guidelines in **Exhibit D.7** and **Exhibit D.8** are based on products typically offered in the United States. Products offered outside the US may require additional analysis reflecting their specific features and ranked accordingly. After evaluating product risk particulars, and reviewing nuances relative to local market conditions, the rating analyst will then refer to **Exhibit D.9** to arrive at the final product risk assessment.

Exhibit D.9: Product Risk Assessment

Component	Positive	Neutral	Negative
Product Risk	Company predominantly carries lower risk product offerings	Company predominantly carries medium risk product offerings	Company predominantly carries higher risk product offerings

Regulatory, Event, Market, and Country Risks

Regulatory Risk

Although regulatory changes are not directly tied to the economy, changes may be necessary in response to other factors such as pricing levels and underwriting results. Regulatory changes are typically targeted to selected lines and markets. Constraints imposed by regulators in the form of

mandated rate rollbacks, extraordinary assessments, and mandatory market lock-in arrangements in catastrophe-prone areas can adversely affect a rating unit.

Event Risk

Event risk can encompass a variety of sudden or unexpected circumstances that may arise. When a sudden or unexpected event occurs, AM Best evaluates the financial and market impact on the insurer, such as the potential for major business and distribution disruption associated with significant litigation; the potential for a "run on the bank" due to a loss of policyholder/distributor confidence; the possibility of economic collapse; or the enactment of significant legislation. Some events may also affect an insurer's reputation, which can limit its ability to maintain its customer base and/or develop new business. Event risk may include changes in management, ownership, parental commitment, or distribution; a legal ruling; or a regulatory development. Finally, event risks also can be influenced by regulatory or legislative reforms, economic conditions, interest rate levels, financial market performance, and societal changes. For international companies as well as domestic insurers operating abroad, political climates and sovereignty risks also may have a significant bearing on event risk.

Insurance Market Risk

Insurance market risk reflects the potential financial volatility that is introduced by, and associated with, the segment(s) of the insurance industry and/or the financial services sphere in which an organization operates. Such risks may also be considered systemic risks and are generally common to all market participants (i.e., financial services reform, health care reform, expansion of alternative markets, and integration of health care providers). Insurance market risk can be viewed either positively or negatively by a number of rating-unit-specific business factors.

Country Risk

The insurance markets in higher-risk countries tend to be less developed, with respect to ease of doing business, contract enforceability, and property rights. In addition, greater risk of political turmoil and/or severe economic conditions could make conducting normal business difficult and regulatory changes more challenging to manage.

After assessing the various regulatory, event, market, and country risks facing the insurer, the rating analyst can then determine the expected rating implications of these risks in line with **Exhibit D.10**.

Exhibit D.10: Regulatory, Event, Market, and Country Risk Assessment

Component	Positive	Neutral	Negative
Regulatory, Event, Market, and Country Risk	Risks are very low or significantly reduced	Risks are moderate and stable	Risks are very high or significantly increased

Innovation

Innovation is becoming increasingly critical to the long-term success of insurers. With innovation, companies can develop sustainable competitive advantages and better respond to external challenges. These challenges may include evolving consumer preferences, growing business complexity, shifting market dynamics, and ever-expanding technological advancements such as AI.

To assess the impact of innovation on an insurer's business profile, and ultimately an insurer's rating, analysts use **Exhibit D.11**. This assessment is relative and does take into account the unique situational characteristics of a particular company, such as their main lines of business.

Exhibit D.11: Innovation

Component	Positive	Neutral	Negative
Innovation	The company's innovation efforts provide it with a tangible benefit	The company's innovation efforts or lack thereof have limited/ no impact	The company's innovation efforts or lack thereof have a negative impact on the company

Business Profile Assessment

The overall business profile assessment is made when each of the sub-assessments described in this section are complete. To do this, the rating analyst will qualitatively combine each of the sub-assessments into a single business profile assessment. The ultimate weighting of each sub-assessment will vary depending on the rating analyst's determination of which metrics will have the biggest impact on the insurer's future financial strength. For example, an insurer could score in the "Positive" or "Neutral" ranges for almost every sub-assessment; however, one "Negative" sub-assessment may result in a final business profile assessment of "Limited" if the rating analyst determines that the risks associated with the single "Negative" metric outweigh all of the other metrics (e.g., if every sub-assessment is "Positive" but the insurer faces high regulatory risks in the near future, the final business profile assessment may be "Limited").

Although the factors discussed have been identified by AM Best as the most important factors for analyzing an insurer's business profile, other metrics may be included if deemed relevant by the rating analyst. When complete, the overall business profile assessment will be made in line with **Exhibit D.12**.

Exhibit D.12: Overall Business Profile Assessment

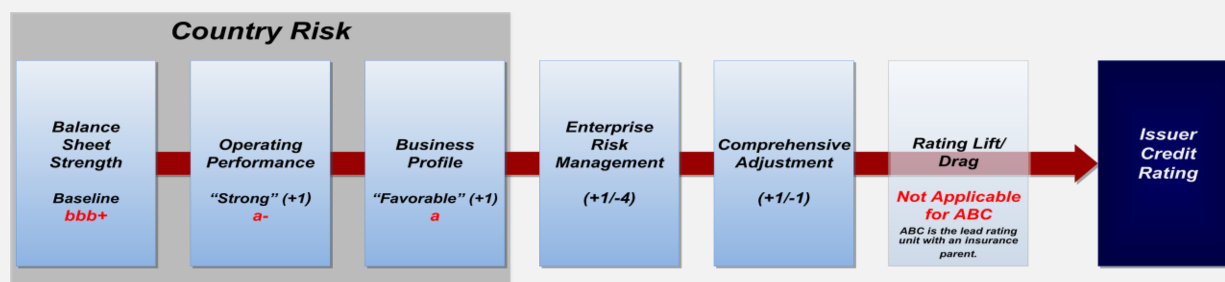
Assessment	Notches	Key Characteristics
Very Favorable	+2	The company's market leadership position is unquestionable, demonstrated, and defensible with high brand recognition. Distribution and innovation efforts have resulted in a competitive advantage; business lines are non-correlated and generally lower risk. Its management capabilities and data management are very strong.
Favorable	+1	The company is a market leader with strong business trends and good control over distribution. It has diversified operations in key markets that have high to moderate barriers to entry with low competition. It has a strong management team that is able to meet projections and utilize data and innovations effectively.
Neutral	0	The company is not a market leader, but is viewed as competitive in chosen markets. It has some concentration and/or limited control of distribution. It has moderate product risk but limited severity and frequency of loss. Its use of technology and innovation is evolving and its business spread of risk is adequate.
Limited	-1	The company has a lack of diversification in geographic and/or product lines; its control over distribution is limited and undifferentiated. It faces high/increasing competition with low barriers to entry and elevated product risk. Management is unable to utilize data and leverage innovations effectively or consistently in business decisions.
Very Limited	-2	The company faces high competition and low barriers to entry. It has high concentration in commodity or higher-risk products with very limited geographic diversity. It has weak data management and its innovation activities or lack thereof have a negative impact of its business profile. Country risk may factor into its elevated business profile risks.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive

Exhibit D.13: Overall Business Profile Assessment for ABC

"Favorable" (+1)			
Components	**Positive**	**Neutral**	**Negative**
1. Market Position	Company able to increase profitable market share at a sustainable rate	Company able to sustain profitable market share	Company unable to sustain profitable market share
2. Degree of Competition	Low competition	Average competition	High competition
3. Distribution Channel	Company has created a significant competitive advantage through its distribution channels	Company has not created a significant competitive advantage or disadvantage through its distribution channels	Company faces a significant competitive disadvantage with regards to its distribution channels
4. Pricing Sophistication & Data Quality	Pricing sophistication and modeling capabilities provide a competitive advantage	Pricing sophistication and modeling capabilities provide no competitive advantage/disadvantage	Lack of pricing sophistication and data modeling capabilities result in a competitive disadvantage
5. Management Quality	Management is proactive to evolving market conditions, consistently achieves forecasts and targets	Management is reactive to evolving market conditions, occasionally falls short of forecasts and targets	Management is unresponsive to evolving market conditions, provides unreliable forecasts and targets
6. Product/ Geographic Concentration	Significant diversification of risks across non-perfectly correlated product lines and geographies	Moderate diversification of risks across non-perfectly correlated product lines and geographies	Insufficient diversification of risks across non-perfectly correlated product lines and geographies
7. Product Risk	Company predominantly carries low risk product offerings	Company predominantly carries average risk product offerings	Company predominantly carries high risk product offerings
8. Regulatory, Event & Market Risk	Risks are very low or significantly reduced	Risks are moderate and stable	Risks are very high or significantly increased
9. Innovation	Innovation provides a tangible benefit	Innovation has limited or no impact	Innovation has a negative impact

The competitive advantage ABC has built through its product/geographic diversification, low product risk, and excellent management capabilities outweighs the more neutral components of its business profile assessment. As a result, ABC will receive a business profile assessment of "Favorable". This will move the baseline assessment up another notch from "a-" to "a".



E. Enterprise Risk Management

Framework Evaluation Review Components		
Risk Identification and Reporting	Stress Testing and Non-modelled Risks	Governance and Risk Culture
Risk Appetite and Tolerances	Risk Management and Controls	

Risk Evaluation Review Components		
Product & Underwriting Risk	Reserving Risk	Concentration Risk
Reinsurance Risk	Liquidity & Capital Management Risk	Investment Risk
Legislative/Regulatory/ Judicial/Economic Risk	Operational Risk	

Introduction

Enterprise risk management (ERM)—establishing a risk-aware culture, using tools to consistently identify and manage, as well as measure, risk and risk correlations—is the common thread that links balance sheet strength, operating performance, and business profile. If a rating unit is practicing sound risk management and executing its strategy effectively, the results will be evident in a prudent and stable level of net required capital and successful performance over the long term. Because ERM is critical to an insurer's long-term success, each rating unit—regardless of its size or complexity—is expected to explain in an integrated way how it identifies, measures, treats, and monitors risk. AM Best believes that ERM capabilities should be viewed in light of a rating unit's scope of operations and the complexity of its business.

An insurer that can demonstrate it has incorporated strong ERM practices into its core operating processes while effectively executing its business plan will be more likely to maintain favorable ratings in an increasingly dynamic operating environment. Strong ERM programs integrate risk metrics into corporate, business line, and functional area objectives, and merge risk-return measures and prospective capital management into financial planning and budgeting, strategic planning, performance measurement, and incentive compensation.

Risk Impact Worksheet

The Risk Impact Worksheet (RIW) is the primary tool that rating analysts use in the ERM assessment process. Using the RIW, AM Best evaluates ERM on three fronts: the unit's risk management framework, its risk management capabilities in light of its risk profile, and its overall ERM.

Importantly, AM Best will apply the proportionality principle in its assessment, and consider the nature, scale and complexity of the company and its activities. In some cases, an insurer may (appropriately) have less complex ERM processes and still function effectively. This may apply to small to medium sized companies with a consistent track record and very stable performance. For example, a disciplined property insurer that operates as a personal motor writer in one jurisdiction, a life company selling traditional protection products through only one permanent distribution channel, or a health insurer writing high-deductible products may not benefit from an extremely sophisticated ERM process above what is needed for their risk profile.

Regardless of the level of complexity, it is critical that a company can demonstrate that the ERM framework in place facilitates the identification, measurement, monitoring and active management of risk.

Framework Evaluation

The risk management framework of an ERM program determines whether an insurer can appropriately leverage the strategic advantages of risk-taking. The ERM framework sets out the tools and/or mechanisms the company needs to deploy its capabilities and address the issues imposed by their risk profile. Building a strong risk management framework enables an insurer to make risk-return tradeoffs that fit its business strategy. Without a defined structure, the value-added features of an ERM program are marginalized and the program is reduced to little more than regulatory compliance. Thus, AM Best's evaluation of an insurer's risk management framework takes a holistic view of the insurer's risk-management system and its associated strategies, processes, tools, and owners. The assessment focuses on five framework components, specifically the insurer's 1) risk identification and reporting, 2) risk appetite and tolerances, 3) stress testing and non-modelled risks, 4) risk management and controls, and 5) governance and risk culture. Each of these framework components is assigned one of the following sub-assessments: "Unrecognized," "Nascent," "Evolving," "Developed," and "Embedded". **Exhibit E.1** describes the typical key characteristics of the sub-assessment descriptors.

Exhibit E.1: ERM Framework Assessment Descriptors

Framework Assessment	Key Characteristics
Embedded	The rating unit has implemented systematic enterprise-wide risk management practices that are appropriate given its profile and that are integrated throughout all levels of the enterprise. The processes in place are robust, regularly updated as needed, and have demonstrated their effectiveness—based on objective measures—during times of significant negative external pressure.
Developed	The rating unit has generally implemented enterprise-wide risk management practices that are appropriate given its profile. Some development work remains, but in general the processes related to the framework component operate effectively. The assessed framework component is integrated and in use throughout the rating unit, but has not been thoroughly tested by external events.
Evolving	The rating unit has implemented some enterprise-wide risk management practices. However, the performance of the processes in place indicates ongoing challenges. Achieving widespread use and/or acceptance of this framework component is a continuing process.
Nascent	The rating unit has recognized the need for enterprise-wide risk management practices and has started the implementation process. However, for the assessed framework component, the processes in place are in the initial stages of development.
Unrecognized	The rating unit has not acknowledged the need for enterprise-wide risk management practices. Formal risk management processes related to the assessed framework component are not in place.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Risk Identification and Reporting

Key to the development of an ERM program is the identification and communication of risks. Risk identification should be a dynamic process that is responsive to the development of new risks resulting from both internal and external changes. An effective ERM program will identify risks across the entire company/rating unit, not just the primary business segment. Any deficiencies or limitations associated with quantitative models should be properly identified. It is important that this process also includes any relevant non-modelled risks.

ERM enables insurers to prioritize among their identified risks by determining which have the greatest strategic importance. It is not enough for senior management—such as the CEO or CRO (if applicable)—and the board to be aware of risks. Risks need to be communicated to the applicable process owners and the responsible frontline management throughout the organization. Successful ERM programs share information across business lines and functions. Communication should occur regularly and within an appropriate timeframe. The identified risks and exposures should be clearly explained to all relevant parties through the use of defined measurements, such as key risk and performance indicators. These metrics should evolve to reflect changing operating environments and

market conditions. The rating unit's adaptability to internal and external events is a component of the evaluation.

Risk Appetite and Tolerances

As part of the ERM evaluation, AM Best will consider the rating unit's in-use risk appetite statement, including its corresponding risk tolerances. A risk appetite statement outlines the level and type of risk a company is willing to accept while pursuing its business strategy. Well-developed statements clearly demonstrate the linkage between business objectives and key risks. Additionally, all rating units should translate their more general statement into narrower risk tolerances and limits. These risk tolerances and/or limits should be accompanied by defined action plans for instances in which the tolerances / limits are exceeded. Quantifiable risk tolerances and limits with supporting qualitative statements are indicative of a strong ERM framework. When reviewing a rating unit's risk appetite and tolerances, the rating analyst would also look to understand how modeled tail events, especially longer tail events, were considered when developing the risk appetite statement.

The board or senior management of rating units with effective ERM programs communicate the organization's risk appetite and tolerances to those that more directly interact with the risk, facilitating the unit's quick response to emerging trends. The ERM program should also ensure that emerging risks identified at any level within the organization are properly fed back to the top, so that the risk appetite and associated risk tolerance limits are regularly reviewed, reflecting changes in the business environment and market conditions.

Stress Testing and Non-modelled Risks

Rating units should be stress testing their operations, using infrastructure that is robust and comprehensive and also consistent with the level of complexity and risk within the unit and should consider all of the critical risks. Stress testing should be actionable and accompanied by contingency plans addressing how to remediate stress scenarios. In cases where quantification of a risk is not feasible or there is a lack of reliable data, relevant hypothetical scenarios and mitigating actions may be reviewed.

A rating unit's stress testing program is a key indicator of the strength of its ERM framework. The stress testing conducted by an insurer needs to be appropriate for the complexity and nature of its risks. Stress testing should extend beyond basic regulatory requirements and should, at minimum, reflect the severity and correlations experienced in historical worst case scenarios.

The analyst will typically assess the appropriateness of the stress testing performed – added credibility to this process would normally be given to evidence that back-testing and reverse stress testing are regularly used - and whether outcomes of the program and mitigating actions are known by the board and senior management. For example, the rating unit would need to explain how it performs under more severe tail events, what the events are which cause the rating unit to breach its risk tolerances, and how its internal modeling of tail events may differ from external model results (including BCAR). To complement the discussion of an insurer's internal stress testing activities, analysts may discuss a

company's Best's Capital Adequacy Ratio (BCAR) results at the 99.8 confidence level as AM Best expects an insurer to consider its tail risk. The rating unit should be able to explain in detail why they feel comfortable when external modeled stress results differ from their own findings and how these risks are mitigated.

Risk Management and Controls

The structure and effectiveness of the risk and control environment of an ERM program can dictate its success. Rating units with effective risk management frameworks are able to demonstrate that their risk responses have been successfully carried out. They are able to provide examples of identified issues and the corrective measures that were taken in order to rectify these issues.

The following factors may contribute to the evaluation: the independence of the risk management function, the timeliness and accuracy of reporting, the extent to which controls are integrated across the relevant levels of the organization, the effectiveness of the controls in place, the use (but not overreliance) of a capital model to drive risk management, treatment and understanding of model limitations and the insurer's overall system of risk checks and balances. The rating analyst may also consider whether the rating unit's risk management strategies and controls are sufficiently dynamic, in light of both its current exposures and its future plans, and remain in line with the rating unit's prospective capital management.

Governance and Risk Culture

Accountability is a core element of any ERM program. A strong risk-aware culture is based on a common language and understanding of risk among corporate officers and directors that enables collaboration across an enterprise. An essential part of assessing an insurer's risk management capabilities is gaining an understanding of an organization's corporate culture and the degree to which risk management is embedded within the organization's decision-making process. AM Best believes effective ERM starts at the top. In order to set the tone for sound risk management, clear directives regarding roles and responsibilities should be established by senior management and the board. Ultimately, it is the importance that the board of directors and senior management place on risk management that will determine the extent to which ERM is integrated across the entire organization.

The evaluation may focus on the rating unit's defined risk management roles and the clarity of assigned responsibilities. The rating analyst may look for key indicators as to the importance of ERM in the rating unit's culture. Examples include whether 1) ERM has clear sponsorship from management, 2) the appropriate staff (in terms of numbers, technical skills, and seniority) is dedicated to risk management functions, 3) a common set of risk-based rules governing accountability and incentive compensation are in place, 4) alignment between risk strategy (including capital management) and strategic business plan and 5) ERM is implemented as a continuously evolving process.

Risk Evaluation

The second area of focus in AM Best's ERM evaluation is an assessment of an insurer's risk management capabilities relative to its risk profile, again using the RIW. The RIW contains eight broad

categories of risk. For each risk category, the analyst will assess the risk management capabilities of the insurer to see how they align with the risk profile. The risk categories found on the RIW are product & underwriting, reserving, concentration, reinsurance, liquidity & capital management, investments, legislative/regulatory/judicial/economic, and operational. Examples of possible areas of evaluation in each risk category follow, but are not intended to be an all-inclusive list of possible risks assessed. In addition, a rating analyst may not need to evaluate each of the items noted, depending on the risk profile of the rating unit being evaluated.

Product & Underwriting

Risk Profile

The assessment focuses on the main characteristics of the rating unit's specific products and on the factors that make them more or less risky, taking into account any diversification benefits. The historical frequency and severity of losses in a particular product line influence the rating analyst's assessment of a rating unit's underwriting risk.

Management Capabilities

The management team's achievements in implementing product changes and embedding risk mitigation strategies in the rating unit's product offerings, pricing, benefits, and limits are evaluated. Management is also assessed on how effectively it manages correlation in the mix of product offerings.

Reserving

Risk Profile

For reserving risk, the review includes the rating unit's historical reserve adequacy, current reserve position, as well as sensitivity to market changes. All business segments (e.g., life, health, P/C, title) have specific reserving requirements. The rating analyst may discuss the factors affecting the riskiness in setting reserves for the products sold by the rating unit.

Management Capabilities

The rating analyst may consider management's philosophy (midpoint, margins, etc.), line of business adequacy trends, results of cash flow testing, accident- vs. calendar-year results, reserving process, use of captives, track record, and experience of actuarial staff. The rating analyst may also evaluate the rating unit's ability to implement future rate increases and lessen its reliance on releases.

Concentration

Risk Profile

Contributing to the rating unit's risk profile for this risk category are any concentrations in areas such as investments, product offerings, geography, sources of earnings, distribution channels, regulatory environment, or other business operations (excluding reinsurance counterparty concentration, discussed later). Typically, higher concentrations result in higher risk profiles.

Risk Management Capabilities

The rating analyst may consider how the rating unit actively identifies, addresses, mitigates, and controls its exposure to risks caused by concentrations. The rating analyst may also make a judgment

on how successful management is likely to be in reducing the potential impact of these risks and its past track record in doing so (e.g., length of time in a given concentrated product/market/region).

Reinsurance

Risk Profile

Reinsurance can be an effective tool for managing insurance risks. However, the use of reinsurance creates a host of new risks for the ceding rating unit. Counterparty credit and concentration risk, dispute risk, inappropriate/poorly designed reinsurance programs, dependence on reinsurance for ratings/solvency/growth, increased costs of reinsurance and associated recordkeeping, unstable reinsurance pricing/market, oversight and type of collateral, and reliance on third-party brokers are just some of the risks associated with reinsurance.

Risk Management Capabilities

The specific types, reliance, counterparty credit quality, and levels of reinsurance used by the rating unit are reviewed to see if its insurance risks are being properly mitigated. The policies and procedures the rating unit has in place to control the credit, dispute, and dependence risks created by using reinsurance are also considered.

Liquidity & Capital Management

Risk Profile

Assessing financial flexibility risks requires understanding the rating unit's own financial wherewithal and ability to raise any needed funds in a timely and cost-effective manner. If the rating unit is reliant upon an affiliate, an IHC, private owner, or other funding mechanism, the assessment would also factor in that group's ability to raise capital in a timely and cost-efficient manner. The financial flexibility of the rating unit should incorporate the need to absorb losses and finance growth, in addition to potentially supporting parent or affiliated entities. AM Best believes that a rating unit without debt is still exposed to these risks

Risk Management Capabilities

Rating analysts may assess the rating unit's ability to manage capital such that if it had a sudden large loss of surplus, it would be able to quickly and efficiently access funds. Other areas of review would include the unit's overall philosophy toward capital management (e.g., aggressively leveraged, unladdered maturities; levels of capital held at subsidiaries; rating triggers), leverage/coverage position compared to peer groups, and shorter- vs. longer-term liquidity needs.

Investments

Risk Profile

The rating analyst should review the investment mix and duration, which are expected to reflect the rating unit's liability profile and should not change materially year over year. The ability to take on more investment risk should be balanced by the unit's capabilities and the amount of underwriting risk it undertakes. The rating analyst can also review the investment risk profile compared with peers and the industry.

The riskiness of a rating unit's invested assets would be affected by default and interest rate risk on bonds, market risk on stocks, and liquidity risk on all asset types. Investments are viewed in light of the rating unit's asset liability management (ALM) philosophy, reflecting both not just expected, but also any potential liability and liquidity needs. Comparing the rating unit's asset allocation to the average peers' asset allocation may indicate the relative riskiness of the unit's investment portfolio. A rating unit that cannot match asset duration to liability duration may end up with a higher-risk investment portfolio.

Risk Management Capabilities

Management's ability to create, execute, monitor, and manage an investment policy and portfolio is assessed to determine if it reflects and responds to the liquidity needs and duration of the products and liabilities of the rating unit, as well as being in line with an appropriate ALM strategy. The use of an outside asset manager alone is not considered a "relevant" capability. The outside manager should demonstrate competencies and provide meaningful management information systems to the rating unit which, in turn, can explain its investment strategy to the rating analyst. The insurance management team should also explain what oversight and limitations are placed on external asset managers. Even with the use of an outside manager, the management team should be able to explain the risk in the investment portfolio in light of the rating unit's stated risk appetite measures and demonstrate its performance in stress scenarios.

Legislative/Regulatory/Judicial/Economic

Risk Profile

This risk profile assessment requires an impact review of macro-economic policies and/or other outside influences on the rating unit's risk profile and performance. Influences from market and country risks and other domestic or global macro-economic policies should be reflected here. Any other regulatory, legislative, or judicial exposures that affect pricing and strategy should also be captured here.

Risk Management Capabilities

For this category, the rating analyst should discuss management's ability to identify, monitor, and measure potential losses associated with, or caused by, the relevant outside influences. Only the influences identified by the risk profile review are addressed in the capabilities section. If the potential risk is material, the rating analyst should make an assessment of the rating unit's preparedness to handle the issue.

Operational

Risk Profile

Operational risk is defined as any risk of loss arising from damage to a rating unit's reputation or franchise value caused by external events, inadequate or failed internal processes, or people. Examples of operational risk would include poor data quality, fraud, breaches in internal controls, business disruption, misapplication of AI-enabled tools, and cyber risk.

Risk Management Capabilities

The rating analyst considers the rating unit's access to reliable, accurate, comprehensive, and timely data. Whether breaches in tolerances are reported immediately, duties are properly segregated, and third-party cyber security assessments are conducted are also evaluative factors. Additionally, the rating analyst may take into account the suitability of the rating unit's IT infrastructure, loss data collection and analysis, and disaster recovery plan.

Overall ERM Assessment

The final section of the RIW focuses on an overall assessment of ERM and determines the assessment descriptor and ultimately the notching given to the rating unit. The rating analyst will arrive at an overall ERM assessment as described in **Exhibit E.2**.

The significant amount of potential downside notching (up to -4) reflects AM Best's view that very negative ERM can erode capital precipitously, while also allowing AM Best to account for the discrepancies between markets in different stages of ERM practice development. The limited upside notching for ERM available to insurers (up to +1) is indicative of AM Best's position that insurers' sophisticated ERM is an essential requirement for companies with complex risk profiles. Effectively, there is only so much a strong ERM program can add to the credit rating evaluation, while poor ERM can quickly place a company in distress. Insurers with "Very Strong" ERM have an embedded framework and superior risk management capabilities. They should also be able to articulate the way that the ERM framework adds value to the company.

Exhibit E.2: ERM Assessment

Assessment	Notches	Key Characteristics
Very Strong	+1	The insurer's ERM framework is embedded. The insurer demonstrates market best practice techniques. The results are evident in a prudent and stable level of net required capital and successful performance over the long term. Risk management capabilities are very strong and are suitable for the risk profile of the company.
Appropriate	0	The insurer's ERM framework is developed. Risk management capabilities are well aligned with the risk profile of the company.
Marginal	-1	The insurer's ERM framework is evolving. Risk management capabilities show some weakness in key risk areas.
Weak	-2	The insurer's ERM framework contains some nascent elements. Risk management capabilities are largely not aligned with the risk profile of the company.
Very Weak	-3/4	The insurer's ERM framework is unrecognized. Risk management capabilities relative to the risk profile of the company are not aligned.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

Exhibit E.3: ERM Assessment for ABC

Risk Impact Worksheet

I. Framework Evaluation

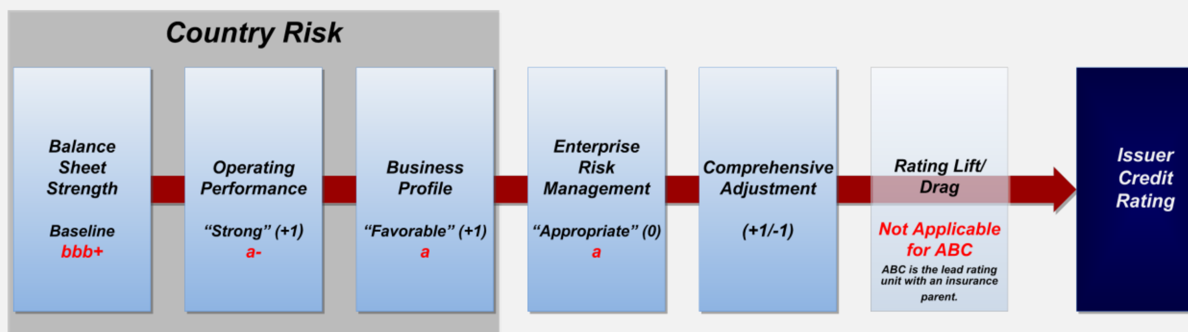
	Unrecognized	Nascent	Evolving	Developed	Embedded	
Risk Appetite and Tolerances Sub-Assessment				▲		Comments
Stress Testing and Non-Modelled Risks Sub-Assessment				▲		Comments
Risk Identification and Reporting Sub-Assessment				▲		Comments
Risk Management and Controls Sub-Assessment				▲		Comments
Governance and Risk Culture Sub-Assessment				▲		Comments

II. Risk Evaluation

	Risk Profile: 1	2 (Low)	3	4	5 (Moderate)	6	7	8 (High)	9	Risk Management Capability	Comments
Product & Underwriting						▲				Appropriate	
Reserving			▲							Appropriate	
Concentration					▲					Appropriate	
Reinsurance				▲						Appropriate	
Liquidity & Capital Management						▲				Appropriate	
Investments			▲							Appropriate	
Legislative/Regulatory/Judicial/Economic					▲					Appropriate	
Operational						▲				Appropriate	

"Appropriate" (0)

The rating analyst, after reviewing ABC's ERM, considers its framework components developed given the size and complexity of its operations. The analyst considers ABC's risk management capability to be appropriate given its risk profile. As a result, an assessment of "Appropriate" is assigned with no adjustment to the work in progress assessment, which is still "a".



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F. Comprehensive Adjustment & Preliminary Assessment

Comprehensive Adjustment

After the ERM review is completed, a comprehensive adjustment may be applied to the recommended rating assessment. A comprehensive adjustment can increase or decrease the recommended rating by a maximum of one notch. The adjustment accounts for circumstances in which, based on a comparison with similar companies, the creditworthiness of the rating unit exceeds or is less than what has been captured through the rating process up to this point.

The evaluation of key rating factors during the rating process includes parameters that place limits on the impact of any one factor. The comprehensive adjustment accounts for and recognizes the uncommon strength or weakness of a rating unit that exceeds or is less than what has been captured through the rating process, and allows for additional weighting beyond the parameters noted for balance sheet strength, operating performance, business profile, and enterprise risk management.

For example, an insurance rating unit may be a truly dominant market leader and a one-notch comprehensive adjustment could be applied to reflect the unique strength that this insurer has in the industry.

Although the vast majority of ratings will not require one, a comprehensive adjustment gives the rating analyst the flexibility to modify, by one notch, the preliminary assessment that has been determined to this point for the lead rating unit.

Exhibit F.1: Comprehensive Adjustment

Assessment	Notches	Key Characteristics
Positive	+1	The company has uncommon strengths that exceed what has been captured throughout the rating process.
None	0	The company's strengths and weaknesses have been accurately captured throughout the rating process.
Negative	-1	The company has uncommon weaknesses that exceed what has been captured throughout the rating process.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

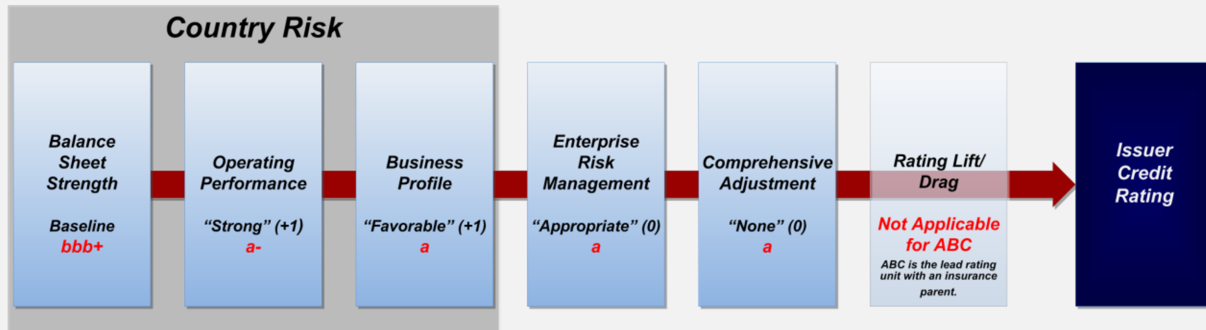
Preliminary Rating Assessment

The determination of the preliminary assessment for the lead rating unit is now complete, incorporating an analysis of the balance sheet strength, operating performance, business profile, ERM, and the comprehensive adjustment as shown in **Exhibit F.2**.

Exhibit F.2: Comprehensive Adjustment and Preliminary Assessment for ABC

"None" (0)

In the case of ABC, there are no instances in which the rating unit demonstrates extraordinary strengths or weaknesses that have not been accurately captured by the rating assessment up to this point. Therefore, the assessment will remain at "a". As ABC is a lead rating unit, it is generally not eligible for rating lift/drag and its ICR recommendation is "a".



G. Rating Lift/Drag

Lead Rating Unit with a Non-insurance Parent

In certain cases, a non-insurance ultimate parent may have an impact (negative or positive) upon the lead rating unit. In these situations, the impact of the non-insurance ultimate parent would be captured in the rating lift/drag assessment. Similar to insurance parents, non-insurance parents are reviewed and analyzed to determine, at a minimum, whether the parent's activities could reasonably be expected to place a call on the capital of the lead rating unit, or expose the lead rating unit to material risk. Typical analysis performed on the non-insurance parent to determine lift/drag is outlined below:

Evaluating Non-Insurance Ultimate Parents

Understanding the potential effect of the activities of the non-insurance ultimate parent on a lead rating unit is an important component in developing a comprehensive view of the unit's risk profile. The owner's ability and willingness to support the insurance rating unit during times of stress must be understood. This analysis becomes potentially more complex when the insurance rating unit is owned by a parent that is engaged primarily in a business other than insurance.

The analysis of the non-insurance owner of a rated insurer includes an assessment of publicly available credit measures, market-based credit measures - such as credit default swap (CDS) prices ("spreads") where available -, and independent financial analysis. The analytical team can use any financial and non-financial information on a non-insurance owner that is available in the public domain, such as news reports and stock reports and recommendations, which can provide valuable insight. The relative weight of the approaches used to generate an assessment of the non-insurance owner is determined by the rating analyst. For example, the rating analyst may consider the parent's leverage and the ability to service this leverage from sources other than its insurance operations. A rating analyst's conclusion that the insurance operations could be called upon to service the obligations of the parent could have a negative bearing on the assessment of the lead rating unit, potentially resulting in drag.

Publicly available credit assessments of non-insurance owners include the credit ratings assigned to the company or group by other credit rating agencies (CRAs) with expertise in that particular industry. A major CRA's credit analysis incorporates quantitative and qualitative information from public and non-public sources, in addition to the proprietary expertise the CRA derives from the processes and people involved in assigning a rating. In the case of a non-insurance ultimate parent, AM Best would use a major CRA's publicly available credit ratings to form an opinion of the parent's creditworthiness. The gap between the parent's CRA rating and the relative strength or weakness of the insurance operations will also factor into the determination of lift/drag.

When an insurance rating unit is owned by an individual, the analysis may include a review of their net worth based on personal financial statements or other appropriate financial information. In these cases, the dividend track record and the components of the rating unit's expense ratio may be subject to greater scrutiny.

Given the added complexity that may occur in non-insurance parent organizational structures, under exceptional circumstances, there might be more than one lead rating unit. In these cases, it is expected that there is typically no management overlap or clear synergies between rating units and that each lead rating unit is treated as a separate investment by the parent. Each lead rating unit may be eligible for lift/drag from the non-insurance parent.

Factoring in Government Support

In the case of a sovereign parent, AM Best analyzes the creditworthiness of the government owner, taking into account the sovereign's credit rating information and financial health (including debt and fiscal position), as well as market-based default probability information. The result of this analysis may lead to either lift or drag from the sovereign parent.

Government support, whether explicit (i.e., a written guarantee) or implicit (i.e., non-contractual) support, can have a positive impact on the assessment. Explicit financial support demonstrates the government's commitment to an organization. Such support can take the form of a capital contribution or a contractual arrangement that attests to the commitment. The level of benefit afforded depends on the type of explicit financial support provided.

Implicit support expected from the government is also assessed. The evaluation includes information gathered through detailed discussions with government officials and management to gain a complete understanding of the government's relationship to the organization.

Non-lead Rating Units

Up to this point in the assessment process, the non-lead rating unit goes through the same process as the lead rating unit (i.e., a review of balance sheet strength, operating performance, business profile, ERM, and the comprehensive adjustment). In this step, the lead rating unit may afford lift or drag to the non-lead rating unit based on factors such as integration, strategic importance, and contribution to the overall enterprise.

The non-lead rating unit may be eligible for rating lift based on the benefits it receives from being part of a broader organization (i.e., being affiliated with the lead rating unit). Depending on the outcome of the lift evaluation, the non-lead rating unit could receive the same rating as the lead rating unit. However, the non-lead rating unit does not maintain the lead unit's financial size category; and receiving lift does not imply that positive rating action on the lead rating unit will automatically apply to the non-lead rating unit.

A non-lead rating unit that is part of a broader organization may be eligible for lift depending on its importance to the organization. A non-lead rating unit may not be essential to the organization's success and the sale or run-off of the operation may not imply a radical change in core business strategy. However, AM Best believes that a non-lead rating unit may be important enough so that the organization would incur losses substantially greater than its legal obligation to keep the non-lead rating unit in good financial standing. A non-lead rating unit may also be eligible for lift if it has

benefited from some form of explicit support, such as guarantees, reinsurance, and/or capital contributions. The following are some of the characteristics of a non-lead rating unit assigned lift:

- Is important to the group's business strategy and profile
- 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 benefitted from some form of explicit parental support
- Is highly likely to receive future support

The non-lead rating unit may also receive rating drag from its affiliation with the lead rating unit. Drag may also occur for non-lead rating units that have stronger characteristics than the lead rating unit, but are likely to be affected by the entire group's weaker indicators, which are reflected in the lower rating for the lead rating unit.

Considerations in determining whether drag is not applicable include restrictions for withdrawing capital from the subsidiary, any protection provided to the subsidiary through independent directors or control through unrelated stakeholders, regulatory restrictions, commitments through independent public listings and disclosures, and other measures that may protect the balance sheet of the company.

In the event of financial distress, an organization's available resources, subject to regulatory restrictions, may be used to prevent the group from defaulting on its obligations. Generally, it is uncommon for a subsidiary company to have a higher issuer credit rating than its parent organization. However, there are factors that may protect the financial strength of an insurance subsidiary that the rating analyst would need to consider. Fundamentally, for an insurance subsidiary to have a higher issuer credit rating than its parent organization, it must demonstrate both stronger underlying financial strength, and mechanisms that ensure its independence to protect its balance sheet.

An insurance subsidiary may have the ability to refuse requests for financial assistance from its parent company in favor of maintaining its own financial strength. AM Best would seek to understand how the subsidiary's balance sheet is protected from any outside influence from related parties. Other important factors may include:

- The independence of the board of directors and management team
- Separate listing and public disclosures and commitments on stock exchanges
- Independent third party shareholders with sufficient voting power
- Regulatory requirements that restrict the outflow of capital

These elements would need strong governance to ensure control measures are effectively managed.

No Rating Lift or Drag

When a non-lead rating unit is currently viewed as an investment (even a successful one) and is not yet considered a key component of the organization's long-term strategy, it would not receive any lift. Rating units that do not receive lift tend to have the following characteristics:

- Have a marginal or incidental status to the organization's overall strategy
- Can be readily sold without material impact to the group's ongoing operations
- Have a separate operating platform
- Are managed independently, with a separate market identity
- Provide no meaningful diversification benefits
- Are not a significant contributor to earnings or capital

Importantly, non-lead rating units that do not receive lift may still receive drag due to their association with a weaker lead rating unit. In some instances, drag may not apply to a non-lead rating unit with stronger characteristics than the corresponding lead rating unit. For example, the non-lead rating unit may consist of a sub-group of companies specializing in a particular type of business—which is clearly identifiable and separate from that of the rest of the group—and is (normally) subject to a different regulatory framework and jurisdiction, with clear regulatory restrictions on the flow of capital within the wider group.

For illustration purposes, **Exhibit G.1** lists typical rating lift/drag ranges.

Exhibit G.1: Rating Lift/Drag Assessment

Assessment	Notches	Key Characteristics
Typical Lift	+1 to +4	The rating unit receives explicit support from the financially stronger broader organization and/or is deemed materially important to it, as demonstrated by its level of integration.
Neutral	0	The rating unit does not receive explicit support from the broader organization of similar or higher financial strength and/or is not considered materially important to it.
Typical Drag	-1 to -4	The rating unit is negatively impacted by its association with the financially weaker broader organization.

The key characteristics described for each assessment category are ideal scenarios and are not intended to be prescriptive.

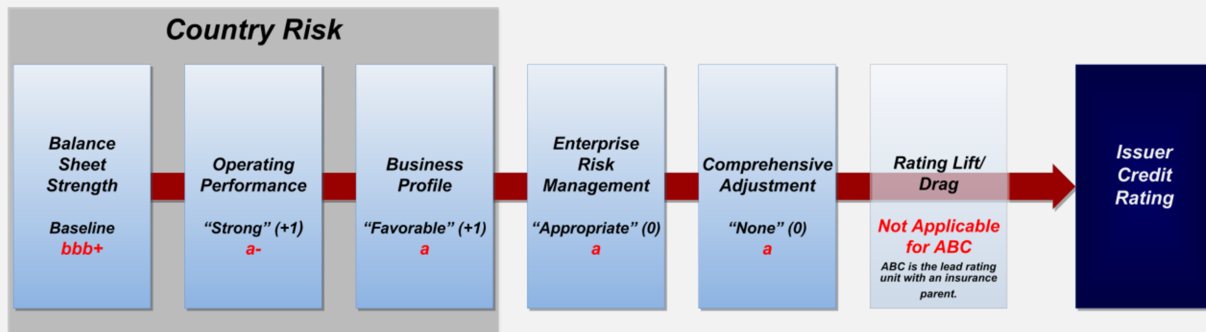
H. Recommended ICR

After the analysis of support is complete, the rating recommendation process concludes with the rating unit's recommended ICR, as shown in **Exhibit H.1**. It is the recommended ICR that is reviewed by a rating committee, which determines the final outcome.

Exhibit H.1: Recommended Issuer Credit Rating for ABC

"Not Applicable" (0)

ABC is the lead rating unit. Thus, the impact of the IHC/group has already been factored into its balance sheet strength assessment and it cannot receive rating lift or drag. The recommended ICR for ABC is "a". Following submission for review, the rating recommendation is then presented to a Rating Committee, which votes on and approves all rating recommendations.



Part IV: Insurance Holding Company and Issue Credit Ratings

Outline

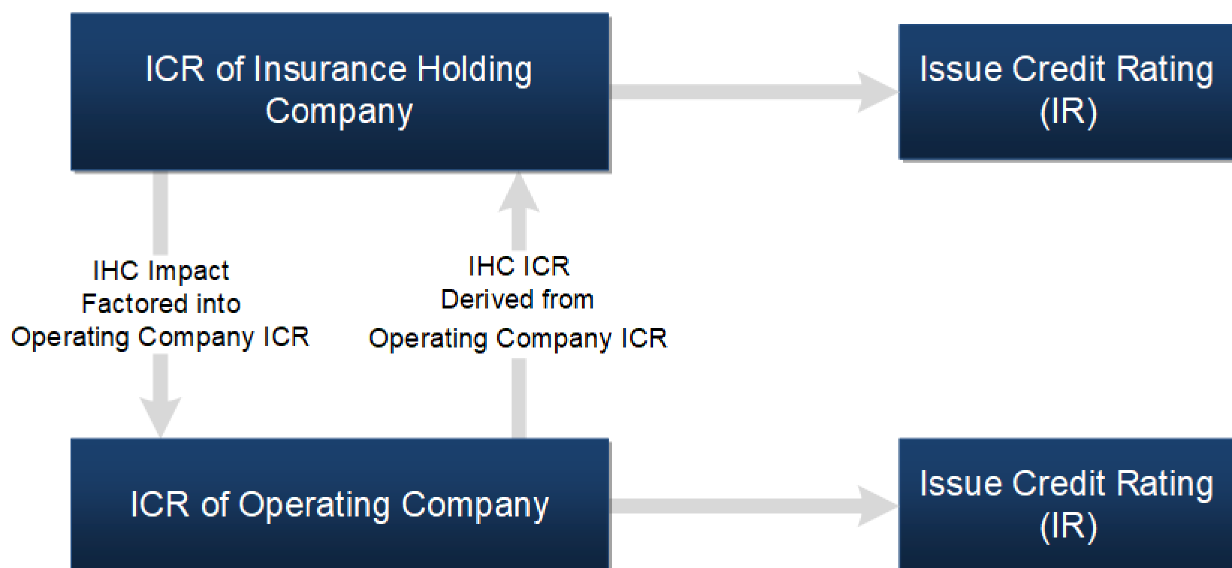
A. Introduction
B. Rating an Insurance Holding Company (IHC)
C. Issue Credit Ratings

A. Introduction

AM Best ratings include: Best's Financial Strength Ratings (FSRs), Best's Issuer Credit Ratings (ICRs), and Best's Issue Credit Ratings (IRs). All of these credit ratings are forward-looking, independent, and objective opinions about insurers', issuers', or financial obligations' relative creditworthiness. **Part III: The Rating Process** focused primarily on AM Best's process for determining an operating company ICR, which can be directly translated into an operating company FSR. This section discusses AM Best's process for rating IHCs and debt (issue).

An operating company ICR is the foundation for an IHC ICR. Issue Credit Ratings—such as debt ratings (both short- and long-term) and preferred stock ratings—are also founded upon ICRs and can be derived from both operating and IHC ICRs. **Exhibit A.1** illustrates the relationship between the IHC ICR, the operating company ICR, and Issue Credit Ratings.

Exhibit A.1: Relationship Between Different Ratings



The notching difference between an operating company ICR and an IHC ICR depends on the following:

- The rating level of the particular operating company

- Group capital fungibility – the fungibility of available capital across entities ultimately owned by the IHC and the IHC itself
- Other relevant features such as the degree of successful diversification evidenced at the IHC
- The group's prudential regulatory oversight

Additionally, the notching difference between the ICR of an operating company and that of an IHC normally widens as the creditworthiness of the operating company declines (see **Exhibits B.1 and B.2**).

The ratings assigned to debt and preferred stock depend both on the issuing company's ICR level and the subordination of the security in the capital structure of the issuing company. Subordination of a security in the capital structure determines the notching between the security and the IHC ICR. Differences in the treatment of certain types of securities—such as capital trust securities and junior subordinated debt—have been restricted to maintain a maximum of three levels of notching.

Short-term ratings are discussed in Section C. **Exhibit C.3** shows an initial translation table from ICRs to short-term ratings, such as commercial paper ratings. However, in instances where a particular ICR maps to multiple short-term ratings, a further assessment of liquidity and cash flows will determine the ultimate short-term rating ICR that is assigned.

B. Rating an Insurance Holding Company (IHC)

Part III: The Rating Process discussed how determining a lead rating unit's ICR requires conducting an IHC impact assessment. During the balance sheet strength assessment of the lead rating unit, the rating analyst will review the sources of material risk to the rated entity, including the exposure to risk generated by activities at the IHC and non-rated affiliates. Understanding the potential effect of the IHC's activities on a rated entity is integral to developing a comprehensive view of the rated entity's risk profile. As a result, all ultimate parents are reviewed and analyzed to determine at a minimum, whether the parent's activities could reasonably be expected to place a call on the capital of the lead operating unit or expose the rated entity to material risk — even if no public rating is assigned to the parent. Equally, the IHC is assessed to determine the support it would provide to the rated entity at a time of stress. In this way, the financial position of the IHC is reflected in the ICR of a lead rating unit.

Arriving at the IHC's Rating

The rating of the IHC reflects analysis of both the credit risk implications of the IHC being a separate legal entity from the operating insurer, and the normal subordination of IHC creditors to operating company policyholders in most regulatory jurisdictions. An IHC ICR incorporates the IHC's status as a discrete legal entity separate from the operating insurer. Furthermore, prudential regulation will normally act to restrict IHCs' access to the assets of insurance subsidiaries beyond the usual consequences of separate legal entity status. These restrictions may take the form of maximum dividend levels or other constraints on the movement of funds from operating companies to IHCs.

An IHC normally does not generate significant earnings other than from subsidiary operations, which increases the risk arising from its legal separation from those subsidiaries. These considerations are represented in the notching difference between the ICR of a lead rating unit and that of its IHC.

Regulation

AM Best considers the regulatory regime under which the entity or entities operate to be a key factor in assessing the appropriate level of the notching difference between the ICR of a lead rating unit and that of its IHC. In particular, the regulator's level of oversight over an IHC will be relevant to this assessment, as it significantly determines group capital management and fungibility. The focus of regulatory regimes can vary from those where individual legal entities are the primary concern to regimes where relevant groups of companies are also considered in detail.

AM Best identifies Entity Prioritized Structures (EPS) and Collective Capital Management Groups (CCMG) as categories of insurance groups largely determined by their regulatory environment. In many cases, insurance groups (or subgroups) will have operations across many geographies and be subject to different forms of regulation, i.e., a mix of regimes with variation in their emphasis on legal entities and groups. AM Best will seek to understand the operating environment of the group or company and any restrictions or limitations on the flow of capital this may present for the group. Regulation may influence how a group operates, but an understanding of capital management policy is also important in determining the appropriate level of notching between the lead rating unit and the IHC.

Entity Prioritized Structures

An insurance prudential regulatory environment may be focused on the regulation of each insurance company legal entity separately, with limited or no reference to jurisdiction over any IHC at the top of the corporate structure.

Where an insurance group primarily operates under this type of regulation AM Best may determine the group to be an Entity Prioritized Structure. Such insurance groups would typically exhibit the following characteristics:

- The regulatory regime is associated with restricted fungibility of capital between regulated operating entities in a group and their IHC
- Regulators may gather information about the IHC, but jurisdiction over the IHC is limited
- Excess capital is more likely held at individual operating entities, than at the IHC

Collective Capital Management Groups

An insurance prudential regulatory environment may include detailed reviews of any group of which an insurer may be a part. The group may comprise insurance and other entities, including an IHC, subsidiaries, and any other interests controlled by the group.

When such groups are subject to regulation, AM Best may determine the group to be a Collective Capital Management Group. Generally, the following characteristics are present in these instances:

- The regulatory regime is associated with enhanced fungibility of capital across the group and an ability to deploy group capital to meet requirements wherever they arise in the group
- The IHC's and intermediate IHC's financial obligations are an explicit part of solvency measures enforced by the regulator(s)
- Excess capital is more likely to be held higher up in the group corporate structure and consequently, less capital in excess of regulatory minimums may be held at the operating subsidiary level

These factors favor a reduced notching difference between an operating company ICR and that of the IHC compared to when the group is not a Collective Capital Management Group. AM Best views regulation of groups as a developing form of prudential supervision that brings operating companies and the IHC closer in terms of financial stakeholders' exposure to solvency risk. Nevertheless, the impact on notching of categorization as a Collective Capital Management Group is normally limited in view of the following factors:

- Separate legal entities remain, often in separate jurisdictions. In a credit event, the IHC at the least will be subject to normal restrictions in each jurisdiction based on access to the assets of subsidiaries. Additionally, legal entity regulation remains in force along with associated constraints on the movement of funds.
- Sub-groups may be located outside the authority of the regulatory supervisor of an IHC, impeding the flow of funds across companies in the group
- National supervisors will usually look to protect the interests of policyholders in their territory, which is likely to influence actions in the normal course of supervision even under the territorial purview of a trans-national group regulator. Policyholder compensation schemes differ across territories and varying parties bear the costs, thus reinforcing national authorities' inclination to protect their policyholders when regulating legal entities in their jurisdiction.

Insurance Holding Company Notching

Exhibit B.1 shows typical notching differences for Entity Prioritized Structures. Insurance groups may not fit directly into the CCMG or EPS category, for reasons such as the diversity of a group's operations. AM Best will review such insurance groups on a case-by-case basis considering their nature, scale and complexity. In the event a group is not clearly classifiable in either of the two categories after this review, it will typically be considered as an EPS for IHC notching purposes. Narrower notching may be used for Collective Capital Management Groups (see **Exhibit B.2**).

Exhibit B.1: Typical Notching Differences Between Operating Company ICR and Insurance Holding Company ICR for Entity Prioritized Structures

Operating Company ICR	Insurance Holding Company Notching (-)
aaa	0-2
aa+	2-3
aa/aa-	3
a+/a/a-	3
bbb+/bbb	3
bbb-	3-4
bb+/bb	4
bb-	4-5

For highly rated operating insurers, IHC ICRs are usually two or three notches lower than the operating insurer's ICR. Farther down the rating scale, this may widen to four or five notches. Conversely, for the very strongest organizations, with diversified and successful operations, this notching could be reduced to zero (i.e., if, after taking into account the risks highlighted above, the credit profile of the IHC is still consistent with a rating of "aaa").

The rating unit's balance sheet strength assessment may benefit from any significant liquid assets the IHC maintains that are likely to be available to meet the lead rating unit's ongoing insurance obligations. If these funds are considered to be not available to meet policy and contract obligations but appear to be a sustainable feature of the IHC's balance sheet, the liquidity at the IHC may be factored into the degree of notching between the IHC and the lead rating unit's ICR.

AM Best usually reflects the balance of considerations involved in categorizing a group as a Collective Capital Management Group in a single notch reduction to the notching difference between IHCs and the lead rating unit compared to typical notching for Entity Prioritized Structures (see **Exhibit B.2**). Relevant factors are assessed before determining the notching difference in each case.

Exhibit B.2: Typical Notching Differences Between Operating Company ICR and Insurance Holding Company for a Collective Capital Management Group

Operating Company ICR	Insurance Holding Company Notching (-)
aaa	0-1
aa+	1-2
aa/aa-	2
a+/a/a-	2
bbb+/bbb	2
bbb-	2-3
bb+/bb	3
bb-	3-4

A group not subject to formal group regulation, as categorized under Collective Capital Management Group as defined above, may nevertheless manage its financial obligations to both safeguard IHC creditors and to carefully ensure its capital is freely available to subsidiaries across the group. In exceptional cases, AM Best may make the determination that the group manages capital in a manner that is reliably at least equivalent to the way capital management would function for a Collective Capital Management Group. Notching differences as illustrated in **Exhibit B.2** may be applied in such cases. Successful diversification can further contribute to the security of creditors.

Intermediate Holding Companies

The relationship between intermediate holding companies and their operating insurance subsidiaries is reviewed to assess whether a relevant sub-group is a Collective Capital Management Group and to determine appropriate notching.

Transfer & Convertibility Ceilings

IHC ratings are subject to Transfer and Convertibility (T&C) ceilings. AM Best defines T&C risk as the risk that government authorities will impose capital and exchange controls that would prevent or materially impede the private sector's ability to convert local currency into foreign currency and/or transfer funds to non-resident creditors. AM Best uses a two-step process to calculate the T&C ceiling. The process starts with a sovereign rating and then estimates the likelihood of a government implementing currency restrictions given default. Thus, T&C ceilings are always equal to or higher than a country's sovereign rating.

C. Issue Credit Ratings

If an insurance organization issues public debt, AM Best may assign a rating on the credit quality of the debt issue. The Issue Credit Rating (IR) is established by reference to the ICR of the issuing entity, whether it is an operating company or an IHC.

Rating IHC Debt and Preferred Stock

AM Best views the subordination of the security in the capital structure of the IHC as the primary factor for notching, emphasizing the contractual subordination in the capital structure, rather than the name of the security. The rationale is that in the event the IHC becomes bankrupt, the senior obligations are to be repaid before subordinated creditors receive any payment, as dictated by the flow of funds in the legal documents.

Additionally, loss-absorption features can result in wider notching if the likelihood of a feature taking effect is determined by a trigger that is not sufficiently remote. AM Best views contingent write-downs, equity conversions, and deferral of coupon or interest payments in well-defined and solvent circumstances as potential examples of such features. An aggressive trigger that affects issue notching might, for example, be defined by reference to a regulatory solvency ratio or an earnings threshold. The volatility of an insurer's solvency may influence the assessed proximity of a loss absorption trigger. If a company with an existing issue of subordinated debt issues additional subordinated debt ranked senior to the existing issue, the rating of the prior issue may be downgraded. This approach is consistent with a rating assignment based primarily on structural subordination.

As displayed in **Exhibit C.1**, securities described in the indenture agreement as being senior to all other unsecured obligations receive zero notches from the ICR of the IHC. Securities contractually subordinated only to senior debt receive one notch. Securities contractually subordinated to senior debt and subordinated debt typically receive two notches. Generally, only three levels of notching (0, 1, or 2) are assigned to securities in an IHC, irrespective of the number of securities in the capital structure. AM Best's view is that, in the event of an IHC's bankruptcy, the differences in recovery among securities with two or more notches are unlikely to be significant. As such, instruments with different subordination may have the same level of notching.

Exhibit C.1: Typical Notching Difference Between Non-Operating Insurance Holding Company ICR and Debt and Preferred Stock Ratings

Security Type	Notches from Non-Operating Insurance Holding Company
Senior Debt	0
Subordinated Debt	-1
Junior Subordinated Debt, Trust Preferred, Capital Trust Securities, Preferred Securities/Stock	-2

Although preferred and trust preferred securities are viewed as being less creditworthy than junior subordinated debt, each security is generally rated two notches below the IHC's ICR. If a trust or special-purpose entity issues securities backed by a different class of securities, the securities the trust issues are generally one notch below the securities issued by the insurance entity to fund the obligation, subject to the cap on notching. For example, if AM Best rates trust-preferred issues that are backed by subordinated debt, these issues are rated at the same level as the trust preferred securities, given that the trust-preferred securities are further removed from the cash flows of the operating company. Modifications to this can be made, depending on the details of the issue. If debt subordinated to senior debt is to be issued, and no senior debt existed, the debt would be rated one notch below the IHC, effectively allowing a placeholder in the event that senior debt is to be issued.

Rating Operating Company Debt and Preferred Stock

Ratings of debt issued by operating companies are notched from the published ICR of the operating company. For debt issued by operating companies, the degree of the rated issue's contractual subordination to the most senior creditors (usually policyholders) is reflected in the rating level. For higher-rated insurers, senior unsecured debt most frequently would be rated one rating notch below the ICR (reflecting debt holder subordination to policyholders); subordinated debt, two notches; and so forth. However, for issuers at lower rating levels, notching between policyholder and senior debt-holder obligations may expand as the ICR moves farther down the rating scale. The increase in notching at the lower ICR levels generally reflects the higher probability of regulatory intervention (**Exhibit C.2**).

Exhibit C.2: Typical Notching Difference Between Operating Company ICR and Debt and Preferred Stock Ratings

Issuer Credit Rating (ICR)	Senior Unsecured Debt	Subordinated Debt	Preferred Stock*
aaa/aa/a	1	2	3
bbb+/bbb	1	2	3
bbb-	2	3	4
bb+ or below	3 or more	4 or more	5 or more

**This also applies to junior subordinated debt, trust preferred and capital trust securities.*

In certain jurisdictions, the seniority of policyholders and senior debt holders are *pari passu*—that is, on equal footing. In these cases, senior debt would typically receive zero notches instead of one; subordinated debt would receive one notch instead of two; and preferred stock would receive two notches instead of three.

Short-Term Ratings

Commercial Paper

Commercial paper is defined as a short-term, negotiable, unsecured promissory note, generally issued to meet a corporation's current cash liquidity needs. It often is seen as a prudent source of funding

when matched with a corporation's operating needs, providing diversified and cost-effective funding compared to bank loans. Insurers commonly issue commercial paper to finance premiums and cover other operating expenses.

The evaluation of an issuer's commercial paper reflects AM Best's opinion of the issuer's overall credit quality. As a result, the analytical approach is very similar to that of assigning a long-term rating. However, the long-term rating may not fully determine a short-term rating because of the overlap in rating categories. In these cases, further testing of liquidity and cash flows, together with other short-term credit-quality metrics, is necessary. **Exhibit C.3** illustrates how an ICR translates into a short-term rating. As mentioned, if an ICR maps to two short-term ratings, additional testing will be necessary to determine the IR. For instance, an ICR of a- can be mapped to a short-term rating of both AMB-1 and AMB-2; further analysis would be needed to determine the rating of the issue.

Exhibit C.3: Translation Table between ICRs and Short-Term Ratings

<table>
<tr><th>Long-Term ICR</th><th colspan="5">Short-Term ICR</th></tr>
<tr><td>aaa</td><td rowspan="5">AMB-1+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>aa+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>aa</td><td></td><td></td><td></td><td></td></tr>
<tr><td>aa-</td><td></td><td></td><td></td><td></td></tr>
<tr><td>a+</td><td rowspan="3">AMB-1</td><td></td><td></td><td></td></tr>
<tr><td>a</td><td></td><td rowspan="4">AMB-2</td><td></td><td></td></tr>
<tr><td>a-</td><td></td><td></td><td></td></tr>
<tr><td>bbb+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>bbb</td><td></td><td></td><td rowspan="2">AMB-3</td><td></td></tr>
<tr><td>bbb-</td><td></td><td></td><td></td><td></td></tr>
<tr><td>bb+</td><td></td><td></td><td></td><td></td><td rowspan="11">AMB-4</td></tr>
<tr><td>bb</td><td></td><td></td><td></td><td></td></tr>
<tr><td>bb-</td><td></td><td></td><td></td><td></td></tr>
<tr><td>b+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>b</td><td></td><td></td><td></td><td></td></tr>
<tr><td>b-</td><td></td><td></td><td></td><td></td></tr>
<tr><td>ccc+</td><td></td><td></td><td></td><td></td></tr>
<tr><td>ccc</td><td></td><td></td><td></td><td></td></tr>
<tr><td>ccc-</td><td></td><td></td><td></td><td></td></tr>
<tr><td>cc</td><td></td><td></td><td></td><td></td></tr>
<tr><td>c</td><td></td><td></td><td></td><td></td></tr>
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Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Best's National Scale Rating (NSR): a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services, Inc. (AM Best) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AM Best.

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