Club APREF

A.M. Best's Ratings – Solidité financière des assureurs & réassureurs : évaluation & notation

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A M BEST®

Disclaimer

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Agenda

- **Understanding Best's Credit Ratings**

- **Best's Rating Analysis: Rating Factors**

- **Updates to Credit Rating Methodology**

- **Q&A**

Understanding Best's Credit Ratings

About A.M. Best

Company Overview

- Established in 1899, pioneered the concept of insurer financial strength ratings in 1906

- Worldwide headquarters in New Jersey, USA. Regional centres in London, Hong Kong, Singapore and Mexico City. Representative office located in Dubai

- Specialises in insurance

- Interactive ratings coverage exceeds 3,500 companies, including 200+ captives, in over 85 countries

The Interactive Rating Process

The rating process starts with an in-depth meeting with senior management

Ratings are determined by committee – by majority vote
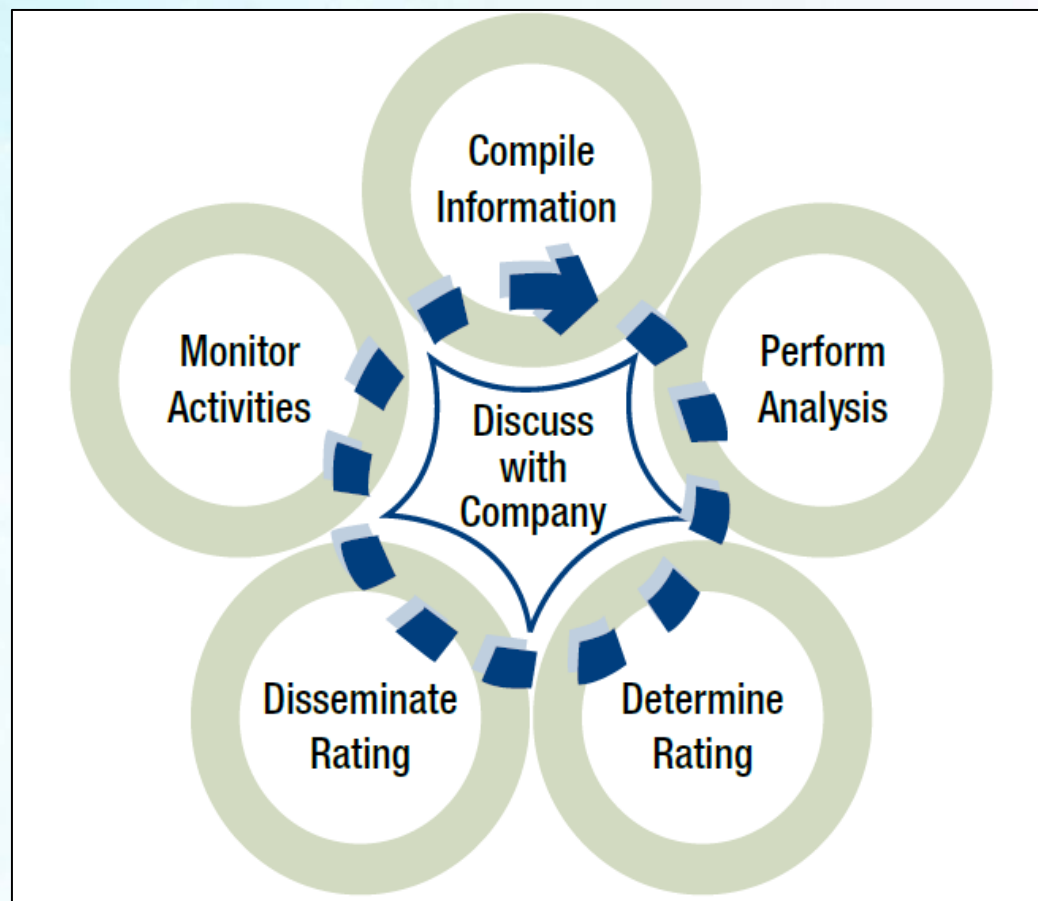
A.M. Best's Rating Process

- A formal rating review at least annually

- Review includes a variety of quantitative and qualitative information

- Interactive process will include one or more meetings with senior management

- Ongoing monitoring - material changes will prompt a review and can lead to a rating action

A.M. Best's Credit Ratings

- **Financial Strength Rating (FSR)**

  – An independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations

- **Long-term Issuer Credit Rating (Long-term ICR)**

  – An independent opinion of an entity's ability to meet its ongoing senior financial obligations

- **Issue Ratings (IR)**

  – An independent opinion of credit quality assigned to issues that gauges the ability to meet the term of the obligation; an IR assigned to a specific issue is an opinion of the ability to meet the on-going financial obligations to security holders when due

Financial Strength Rating and Issuer Credit Rating Translation

FSR	ICR		FSR	ICR
A++	aaa aa+		B	bb+ bb
A+	aa aa-		B-	bb-
A	a+ a		C++	b+ b
A-	a-		C+	b-
B++	bbb+ bbb		C	ccc+ ccc
B+	bbb-		C-	ccc- cc
			D	c

FSR = Financial Strength Rating
ICR = Long Term Issuer Credit Rating

Note: Scales E to NR not shown

Rating Indicators

- **Rating Outlooks**
  - Potential movement in ratings based on current trends
  - Positive / Negative / Stable

- **Under Review**
  - Driven by a recent event or an abrupt change
  - Short-term…typically no longer than six months
  - Positive / Negative / Developing
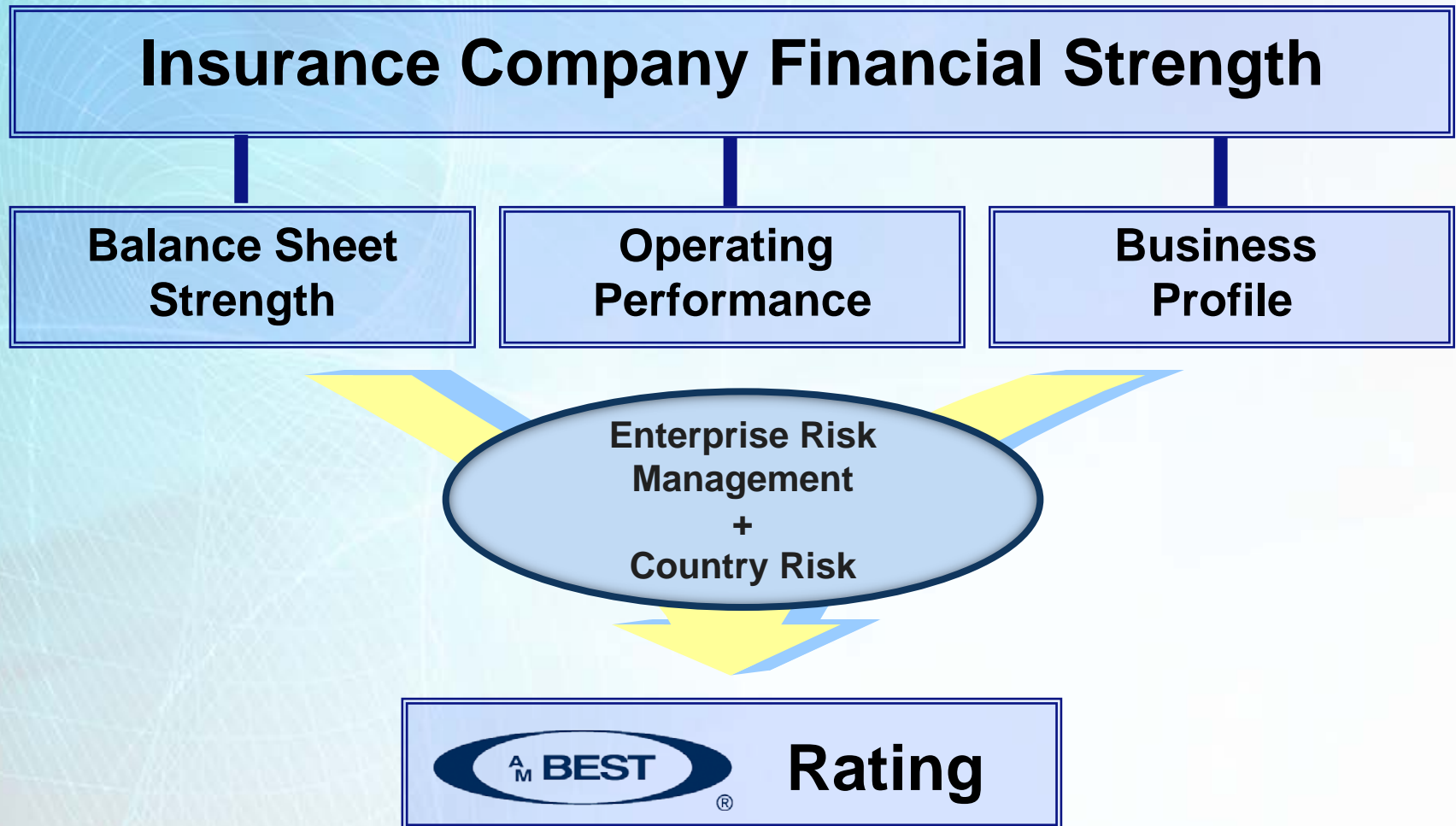
Best's Rating Analysis: Rating Factors

Operating performance and business profile are leading indicators of future balance sheet strength

Strong operating performance builds balance sheet strength

Strong business profile drives strong and sustainable operating performance

Weak operating performance erodes balance sheet strength
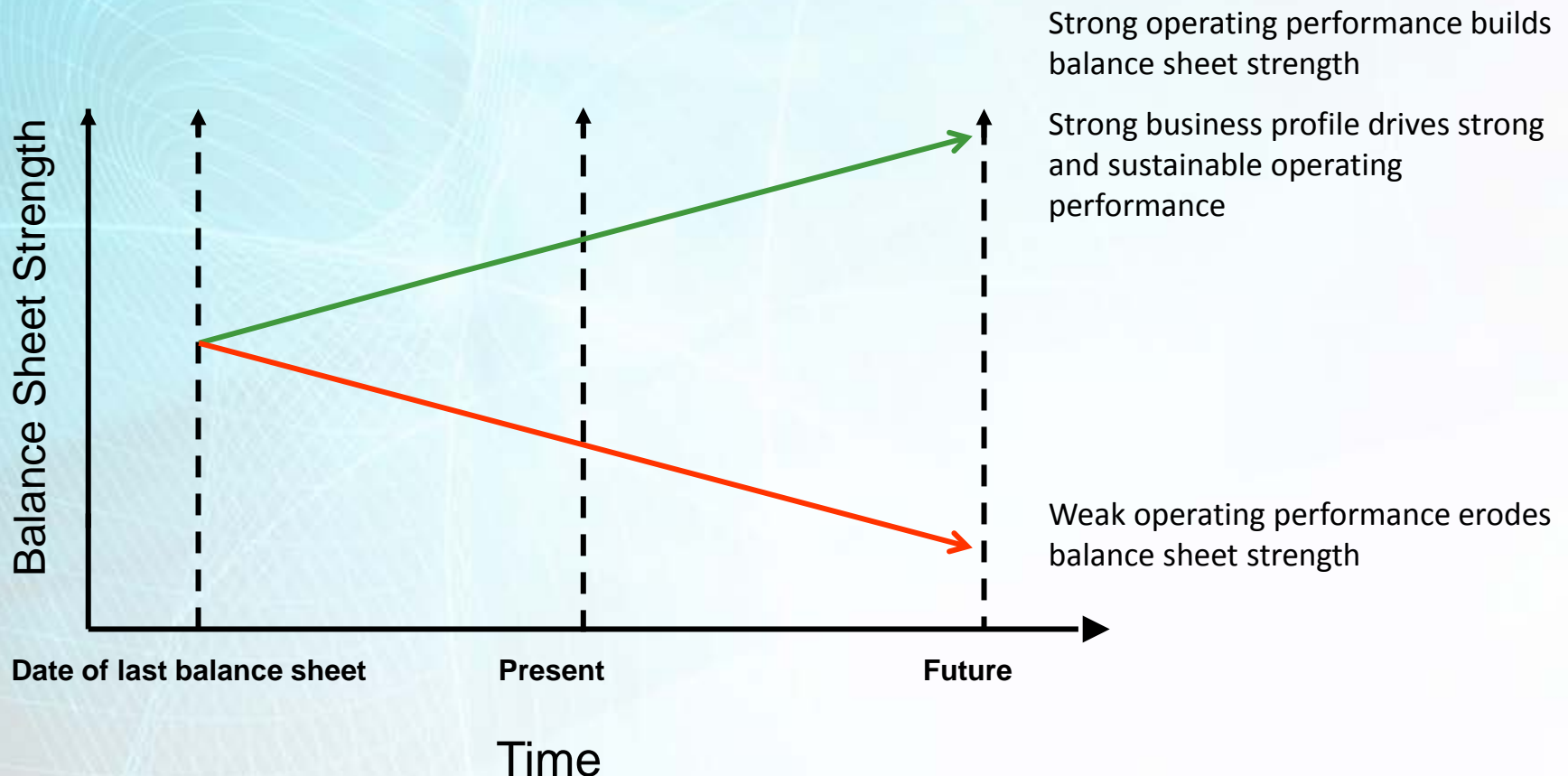
Best's Capital Adequacy Ratio (BCAR) and ERM

BCAR

Weak Risk Management

Strong Risk Management

BCAR Guidelines

Low

High

Exposure to Earnings and Capital Volatility
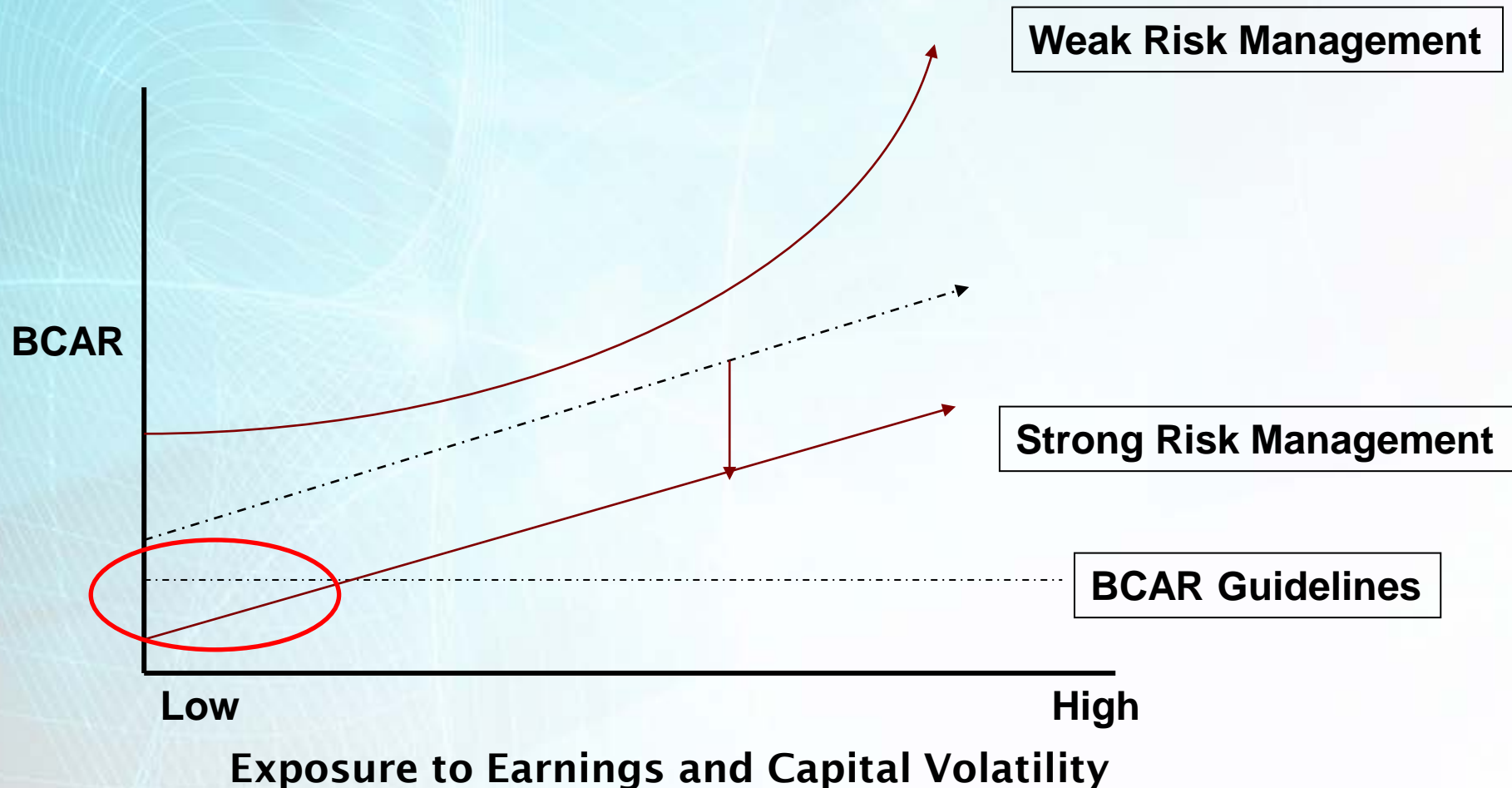
Balance Sheet Strength

- Risk-adjusted Capitalisation as measured by Best's Capital Adequacy Ratio (BCAR)

- Capital structure

- Financial flexibility

- Quality/soundness of reinsurance

- Adequacy of loss reserves

- Quality/diversification of assets

- Liquidity

Operating Performance

- Profitability
  - Historical
  - Prospective

- Revenue composition/quality of earnings

- Sustainability of earnings

- Ability to meet plan

Business Profile

- Market risk

- Competitive advantages

- Diversification

- Event risk

- Regulatory risk

- Management experience and objectives

Enterprise Risk Management

- ERM is the process through which insurers identify, quantify, and manage risk on an enterprise wide, holistic basis

- A.M. Best's approach is non-prescriptive

- A company's risk management capabilities are evaluated in light of its risk profile

- Risk management is not a box ticking exercise

Non-Rated Affiliate Analysis

- Determine if the non-rated affiliate exposes group to material risk and volatility
- Use consolidating income statement/balance sheet
  - e.g. Intercompany loans are eliminated in the consolidation
- Determine if risk is captured in parent analysis
  - If not, conduct more detailed analysis of affiliate
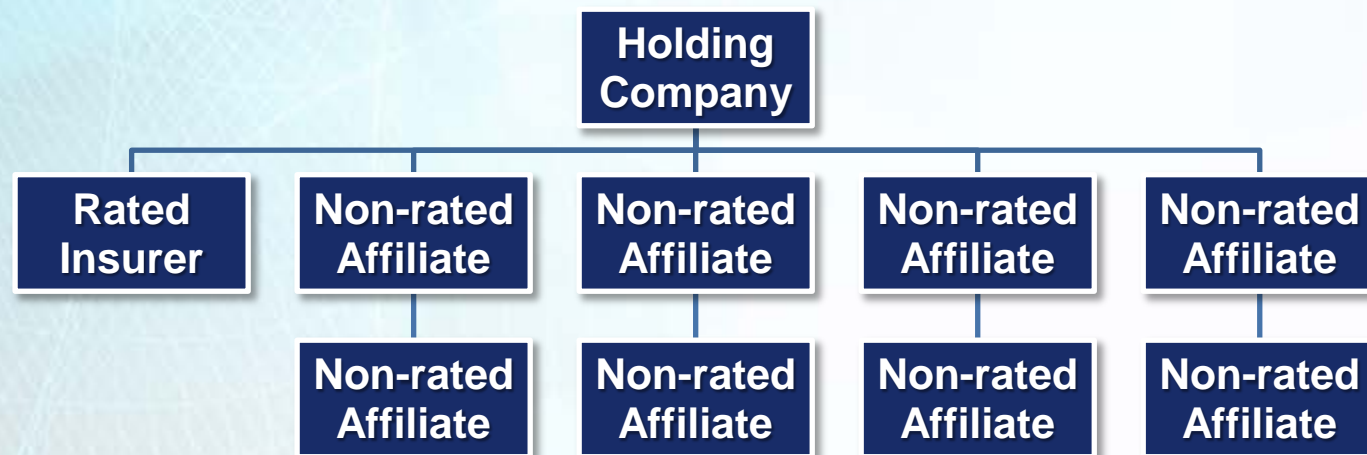
Typical Documentation Requests

- Audited financial statements – company and consolidated

- Strategic business plans

- Details of potential or proposed significant events

- Internal and external actuarial reviews

- Internal guidelines – Underwriting, Investment, Reserving,etc

- Details of performance and expense allocation by class of business

Key Rating Methodologies

Best's Credit Rating Methodology

That includes:

- Risk Management and the Rating Process for Insurance Companies

- Understanding Universal BCAR

- Rating Members of Insurance Groups

- Catastrophe Analysis in A.M. Best Ratings

- Insurance Holding Company and Debt Ratings

- Equity Credit for Hybrid Securities

- Evaluating Country Risk

Best's Credit Rating Methodology Update

Upcoming Changes to Methodology

Best's Credit Rating Methodology is being updated

- **Elements looked at will remain the same:**
  - Balance sheet strength
  - Operating Performance
  - Business Profile
  - ERM
- **Changes aimed at improving transparency**
- **Incorporating changes to Best's Capital Adequacy Ratio (BCAR) model**

The Building Block Approach

- The building blocks themselves will remain the same
- Components of the building blocks are currently being reviewed

A.M. Best's Rating Process
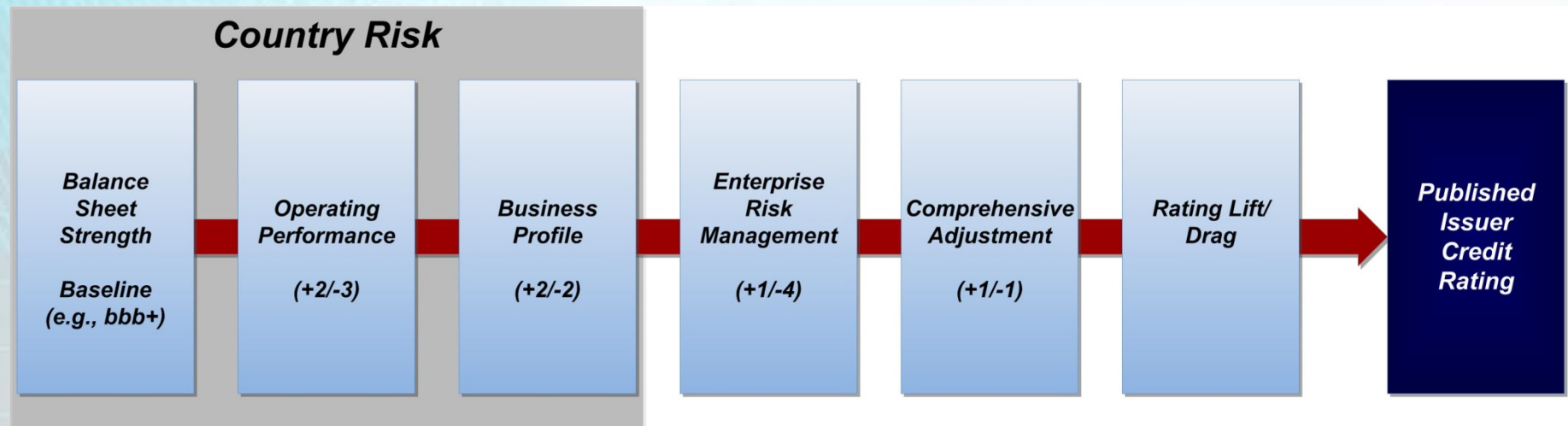
Balance Sheet Strength

- **Balance sheet strength** is now broken down into several parts
  - <u>Rating unit balance sheet strength</u> assessment
    - BCAR
    - Other qualitative and quantitative factors
  - Holding company impact assessment
  - Country risk impact
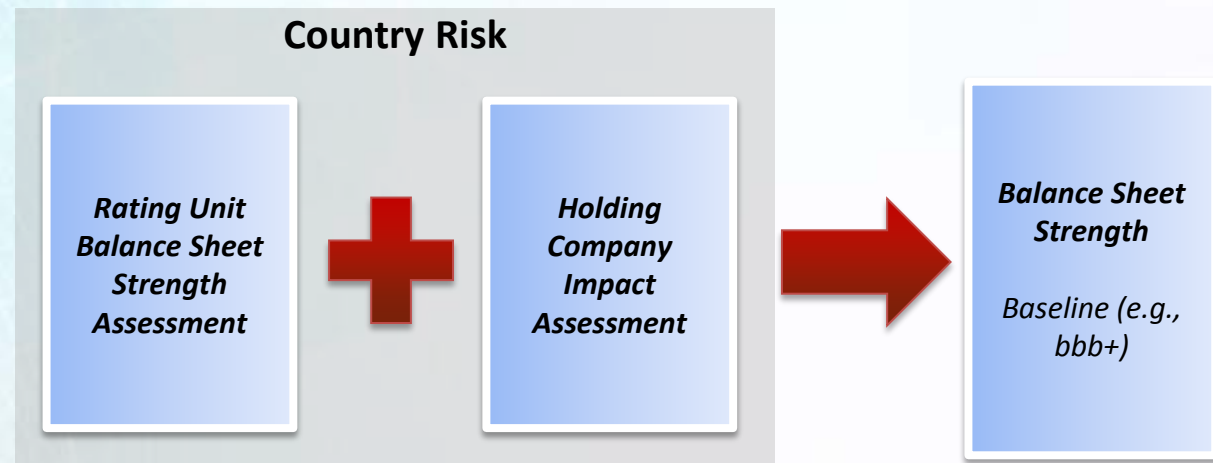
Summary of Changes to BCAR

- **New Calculation of BCAR**
  - Formula change
  - Difference between Available Capital and Required Capital, as a ratio to Available Capital
  - Better alignment with risk appetite/tolerance statements

- **Five scores calculated – instead of one**
  - Using Value at Risk (VaR) metric
  - VaR levels: 95%, 99%, 99.5%, 99.6%
  - VaR 99.8% also modelled but not included in balance sheet assessment

Additional Balance Sheet Factors

Country Risk

Rating Unit Balance Sheet Strength Assessment

+

Holding Company Impact Assessment

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Balance Sheet Strength

Baseline

BCAR
Stress Tests
Liquidity
ALM
Quality of Capital
Quality of Reinsurance
Reinsurance Dependence
Appropriateness of Reinsurance Program
Fungibility of Capital
Internal Capital Models
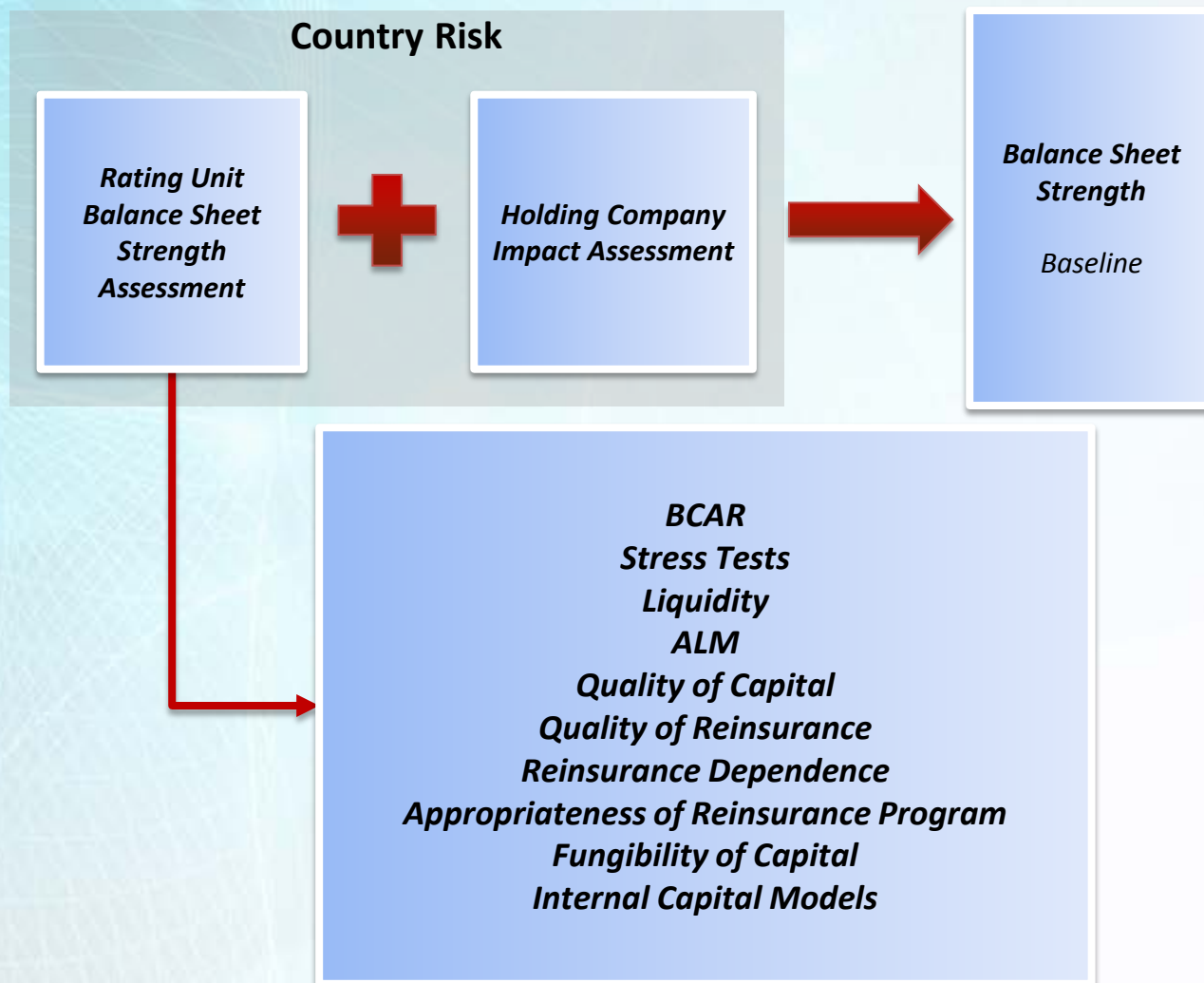
Balance Sheet Strength Assessment

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.

Holding Company Impact Assessment

Country Risk

Rating Unit Balance Sheet Strength Assessment

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Holding Company Impact Assessment

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Balance Sheet Strength

Baseline

**Consolidated BCAR
Financial Leverage
Operating Leverage
Coverage
Financial Flexibility/Liquidity
Intangible Assets**
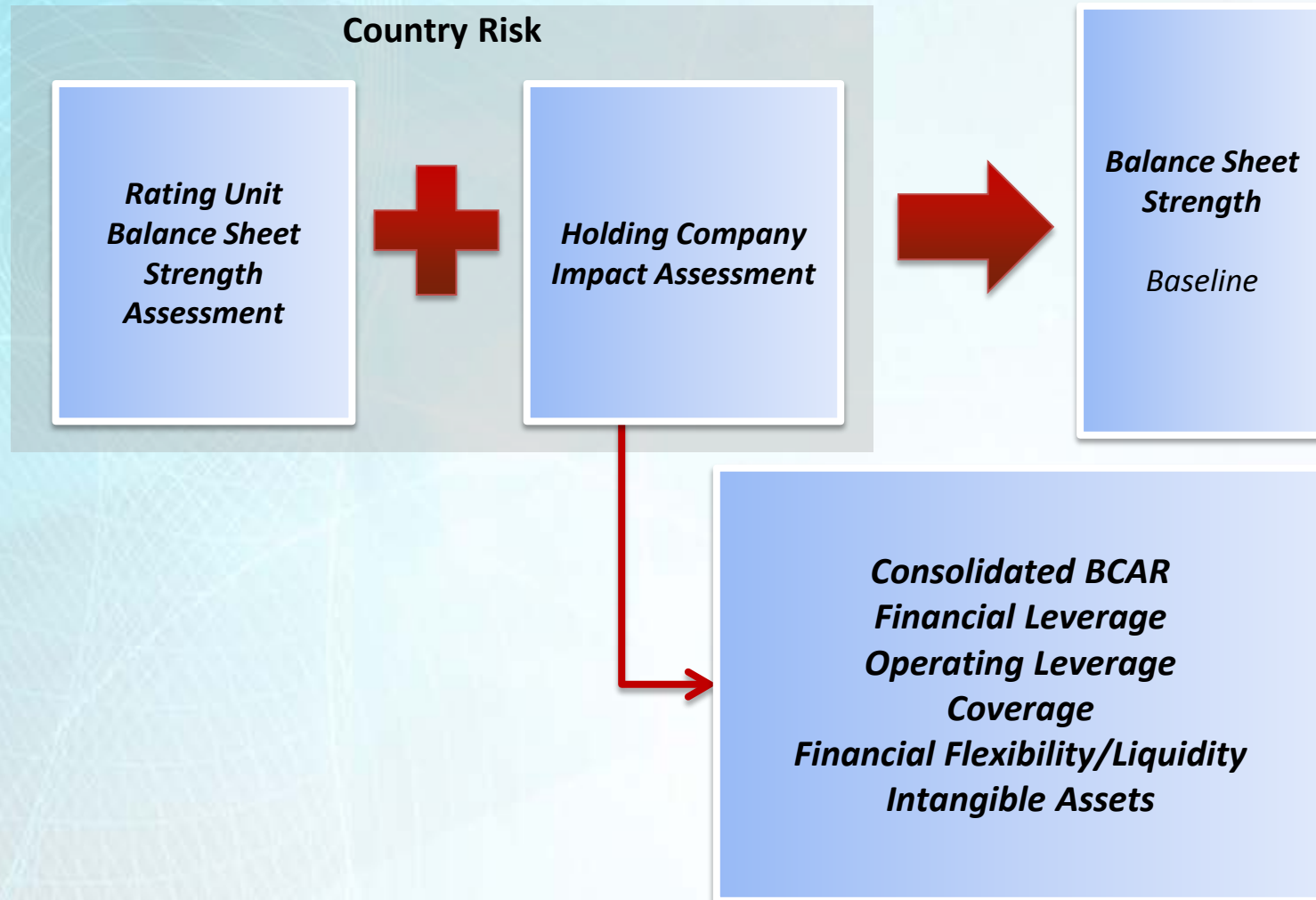
Holding Company Impact Assessment

- **Financial Leverage**
  - Unadjusted / Adjusted

- **Operating Leverage**

- **Coverage**
  - Interest and Fixed-Charge Coverage

- **Financial Flexibility / Liquidity**
  - Analysis of Sources and Uses
  - Access to Capital
  - Asset Allocation / Investment Risk

- **Intangible Assets**

- **Non-Rated and / or Non-Regulated Affiliates**

Balance Sheet Strength Assessment

Combined Balance Sheet Strength Assessment
(Lead Rating Unit and Holding Company)

Holding Company

Lead Rating Unit	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

The Baseline Assessment

Overall Balance Sheet Strength Assessment

Combined Balance Sheet Assessment (Rating Unit / 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-/b+/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 Building Block Approach – Balance Sheet Strength

- **Rating unit balance sheet strength assessment**

  - BCAR
  - Internal capital models
  - Other qualitative and quantitative factors

- **Holding company impact**

- **Country risk impact**

Balance Sheet Only Goes So Far

Impact of Operating Performance and Business Profile on Balance Sheet Strength
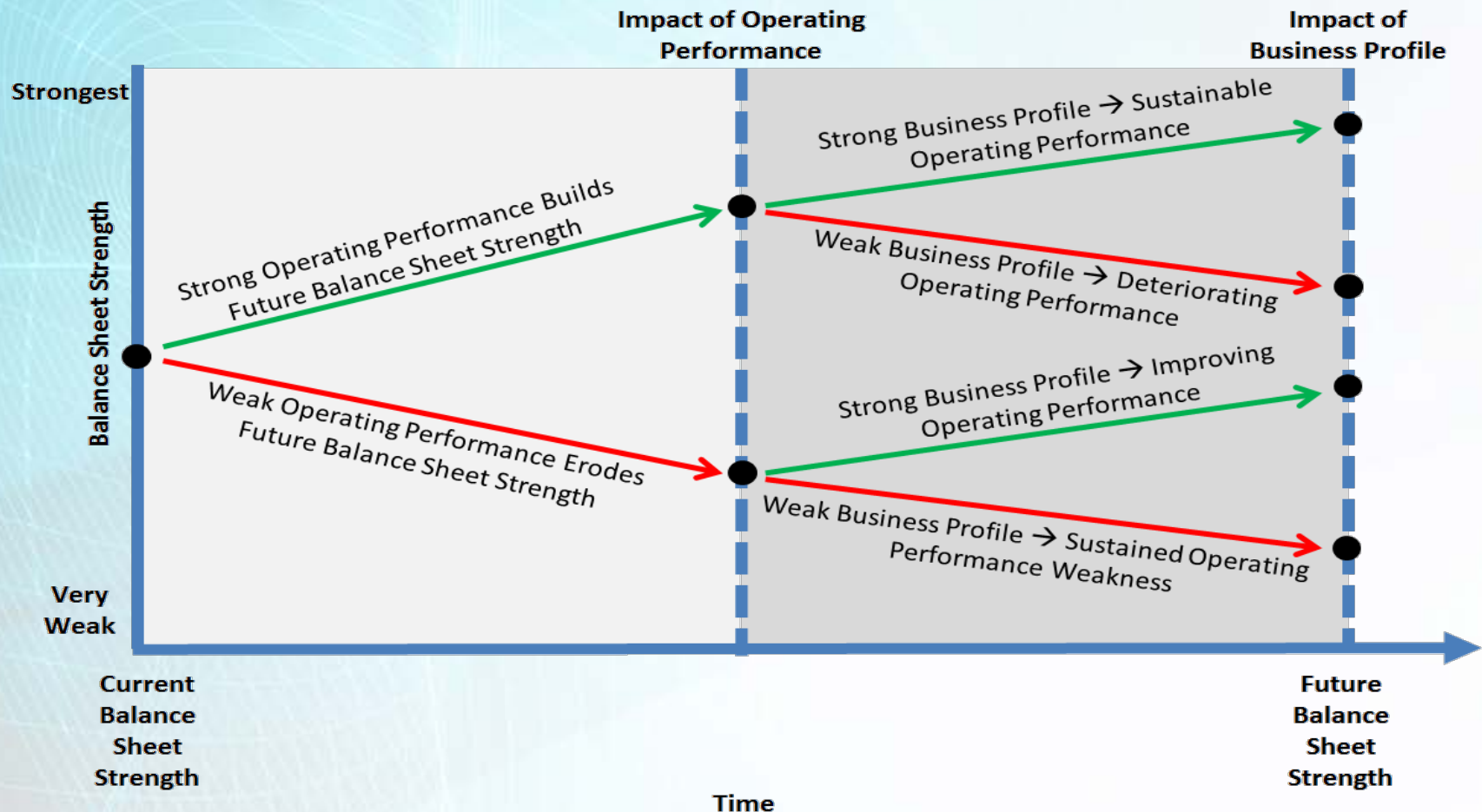
Operating Performance

Underwriting performance

Investment performance

Total operating earnings

Prospective financial forecasts

Other considerations

Unique to LOB, region of operation, structure

Operating Performance Benchmarks

- Benchmarks ensure operating performance metrics for each insurer are being evaluated in proper framework

- Can be created using:
  - Industry composites/sub-composites
  - ICR composites
  - Other customized parameters

- May be appropriate to compare a rating against >1 benchmark

- Rating Committee has flexibility in determining the appropriate benchmark(s) for each rating unit

- Various insurance organizational types will have differing benchmarking metrics

Baseline Adjusted for Performance

Depending on a company's operating performance, the baseline can be adjusted up or down

- – Using appropriate benchmark
- – Looking at level, trend and volatility

Operating Performance Assessment	Adjustment (Notches)	Key Operating Performance 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.
Weak	-1	Historical operating performance is poor. Trends are neutral / slightly negative and prospective operating performance is expected to be poor. Volatility of key metrics is high.
Very Weak	-2/3	Historical operating performance is very poor. Trends are negative and prospective operating performance is expected to be very poor. Volatility of key metrics is high.

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

Business Profile

Review key areas including:

Sub-Assessment	Positive	Neutral	Negative
Product/Geographic Concentration	Significant diversification of product line /geographies	Moderate diversification of product lines / geographies	Insufficient diversification of product lines / geographies
Market Position	Increase profitable market share at a sustainable rate	Sustain profitable market share	Unable to sustain profitable market share
Pricing Sophistication & Data Quality	Provides Competitive Advantage	No Competitive Advantage/Disadv.	Lack of sophistication creates disadvantage
Product Risk	Low Risk Offerings	Average Risk Offerings	High Risk Offerings
Degree of Competition	Low Competition	Average Competition	High Competition
Management Quality	Consistently achieves forecasts & targets	Occasionally falls short of forecasts & targets	Provides unreliable forecasts & targets
Regulatory, Event & Market Risks	Very Low or Significantly Reduced	Moderate and Stable	Very High or Significantly Increased
Distribution Channels	Created a significant competitive advantage thru distribution channels	Has not created a significant competitive advantage thru distribution channels	Faces a significant competitive disadvantage with regards to distribution

Baseline Adjusted for Profile

- Sub-assessments are qualitatively combined by analyst into a single business profile assessment

- Ultimate "weights" of each sub-assessment will vary depending on which metrics will have biggest impact on future financial strength

Business Profile Assessment	Adjustment (Notches)	Key Characteristics of Business Profile
Very Favorable	+2	The company's market leadership position is unquestionable, demonstrated, and defensible with high brand recognition. Distribution is seen as 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 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 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 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. 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.

ERM

Risk Categories:

- Product & Underwriting

- Reserving

- Concentration

- Liquidity & Capital Management

- Reinsurance

- Investment

- Legislative/Regulatory/ Judicial/Economic

- Operational

Baseline Adjusted for ERM

- Analyst assessment of the overall risk management framework that is in place
- Analyst assessment of the rating unit's risk profile relative to its risk management capabilities
- Overall assessment of ERM
  - Evidence of use test, process changes
  - Performance under stressed environments

ERM Assessment	Adjustment (Notches)	Key Characteristics of ERM
Very Strong	+1	The insurer's ERM framework is sophisticated, time/stress tested and embedded across the enterprise. Risk management capabilities are excellent and are suitable for the risk profile of the company.
Adequate	0	The insurer's ERM framework is well developed and is adequate given the size and complexity of its operations. Risk management capabilities are good and are adequate for the risk profile of the company.
Weak	-1/2	The insurer's ERM framework is emerging and management is still developing formal risk protocols. Risk management capabilities are insufficient given the risk profile of the company.
Very Weak	-3/4	There is limited evidence of a formal ERM framework in place. Risk management capabilities contain severe deficiencies relative to the risk profile of the company.

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

Comprehensive Adjustment

- Evaluation of key rating factors includes parameters which place limits on any one factor
- Recognises a truly uncommon strength/weakness that is not captured through the rating process

Comprehensive Adjustment	Adjustment (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.

Rating Lift/Drag

- A non-lead rating unit may be eligible for rating lift based on benefits it receives from being affiliated with the lead rating unit

- Rating drag can also occur from negative impact of the lead rating unit on the non-lead unit

Rating Enhancement/Drag	Adjustment (Notches)	Key Characteristics of Rating Enhancement/Drag
Typical Lift	+1 to +4	The non-lead rating unit either receives explicit support from the broader organization or is deemed materially important within the broader organization as demonstrated by its level of integration.
Neutral	0	The non-lead rating unit does not have explicit support from the broader organization and is not considered materially important within the organization.
Typical Drag	-1 to -4	The non-lead rating unit is negatively impacted by its association with the weaker affiliates of the broader organization.

The Building Block Approach

A.M. Best's Rating Process – Worked Example

Country Risk

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management	Comprehensive Adjustment	Rating Lift/ Drag	Published Issuer Credit Rating
Baseline *bbb+*	"Strong" (+1) *a-*	"Favorable" (+1) *a*	"Adequate" (+0) *a*	"None" (+0) *a*	"N/A" (+0) *a*	

Rating recommendation of "a"

Rating Implications

- BCRM is NOT a means to change ratings although some ratings may change

- Analyst will communicate any potential rating issues to rated companies as they become apparent during comment period

- Ratings impacted will be placed under review at end of comment period
  - Need to be resolved within 6 months after under review

Rating Methodology 2017

- **Released for initial comment period on March 10th, 2016**
  - *Understanding BCAR for U.S. Property/Casualty Insurers*
  - *Best's Credit Rating Methodology*

- **Comment period ended June 30th, 2016**

- **Release of criteria update for further comment on November 14th, 2016:**
  - Revised *Understanding BCAR for U.S. Property/Casualty Insurers draft*
  - Revised *Best's Credit Rating Methodology*
  - Initial draft of *Understanding BCAR for U.S. and Canadian Life/Health Insurers*
  - Initial draft of *Understanding Universal BCAR*

- **Link to methodologies**: http://www3.ambest.com/ambv/ratingmethodology/

Q&A

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