AMERICAN FRATERNAL ALLIANCE

How Changes to BCAR Will Impact Regulators' Opinions of Your Society's Financial Condition

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Pete Wirtala
Insurance Strategist
Asset Allocation & Management

Ken Frino
Group Vice President, Life & Health
A.M. Best Company

About A.M. Best Financial Strength Ratings

An AM Best Financial Strength Rating (FSR) is:

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

Best's Financial Strength Rating (FSR) Scale

Rating Categories	Rating Symbols	Rating Notches*	Category Definitions
Superior	A+	A++	Assigned to insurance companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.
Excellent	A	A-	Assigned to insurance companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.
Good	B+	B++	Assigned to insurance companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.
Fair	B	B-	Assigned to insurance companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
Marginal	C+	C++	Assigned to insurance companies that have, in our opinion, a marginal ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.
Weak	C	C-	Assigned to insurance companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is very vulnerable to adverse changes in underwriting and economic conditions.
Poor	D	-	Assigned to insurance companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations. Financial strength is extremely vulnerable to adverse changes in underwriting and economic conditions.

**Each Best's Financial Strength Rating Category from "A+" to "C" includes a Rating Notch to reflect a gradation of financial strength within the category. A Rating Notch is expressed with either a second plus "+" or a minus "-".*

Used by customers, agents, reinsurers, and other third parties to assess insurer financial strength and evaluate potential business relationships

About A.M. Best BCAR

Best's Capital Adequacy Ratio (BCAR) is an important component of determining an insurer's FSR:

"BCAR calculates the net required capital needed to support the financial risks of the insurer, and compares it with a quality-adjusted measure of the insurer's capital position"

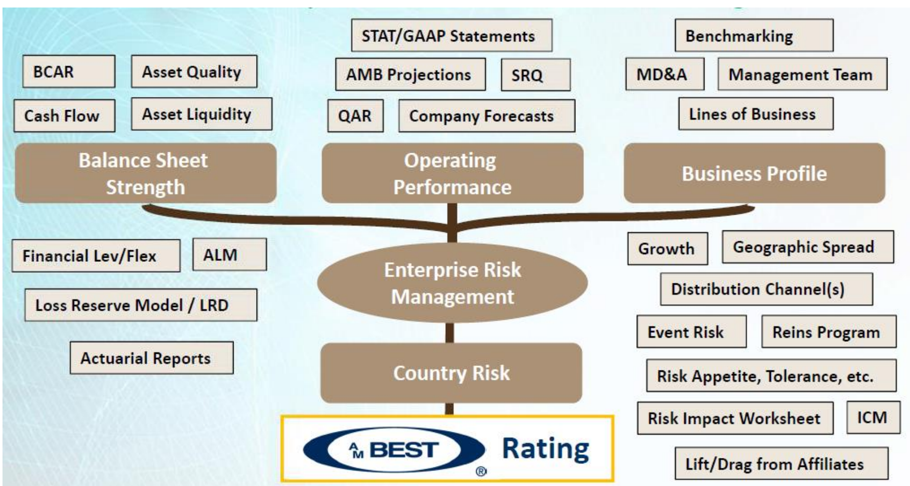
BCAR Ratio = Adjusted Surplus / Net Required Capital

Adjusted Surplus (APHS)	Net Required Capital
Reported Surplus (PHS)	Gross Required Capital (GRC):
Equity Adjustments:	(C1) Asset Risk
AVR Reserves	(C2) Insurance Risk
Interest Maintenance Reserve	(C3) Interest Rate/Market Risk
Unearned Premiums (DAC)	(C4) Business Risk
Debt Adjustments:	
Surplus Notes	Covariance Adjustment
Debt Service Requirements	
Other Adjustments:	Net Required Capital (NRC)*
Future Operating Losses	
Future Dividends	
Derivatives Off Balance Sheet	
Goodwill	
Other Intangible Assets	
Minority Interests, etc.	

*NRC= SQRT [$(C1NonEq + C3interest)^2 + (C1Eq + C3market)^2 + (C2)^2$] + C4

What is the relationship between BCAR and FSR?

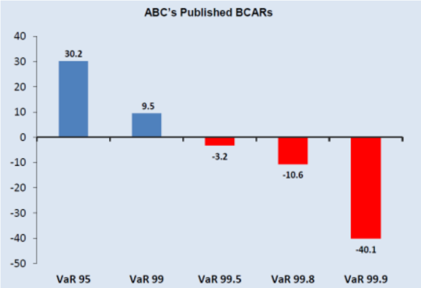
It's complicated…



The Times They Are A-Changing

Important changes are coming to the way BCAR is calculated:

- An Economic Scenario Generator (ESG) statistical model will be used to calculate many risk factors
- Instead of receiving a single BCAR score, companies will receive 5 scores scaled to 5 different statistical confidence intervals:



- The scaling of scores has changed. Previously a 100 score signified that required capital was equal to available capital, but now that status will correspond to a 0 score.
- A.M. Best is moving away from publishing indicative BCAR scores for different letter ratings. This reflects the fact that BCAR is just one of many factors used to determine ratings.

AAM Insurance Investment Management

Investment Portfolios and Multiplying Factors

How will these BCAR changes affect investments specifically?

- Bond factors are going to change. They will now be based on the aforementioned ESG, will incorporate both quality and maturity, and will presumably change over time

- The use of multiple confidence intervals will increase emphasis on tail risks, may incrementally de-incentivize riskier assets

YE 2014 Bond Risk Factors

			Using P/C Industry's Bond Mix				
	Percent of Total	Current BCAR	VaR 95	VaR 99	VaR 99.5	VaR 99.8	VaR 99.9
NAIC 1	82.2%	1.0%	0.7%	1.1%	1.3%	1.5%	1.7%
NAIC 2	13.7%	2.0%	4.1%	5.4%	5.9%	6.4%	6.9%
NAIC 3	2.2%	4.0%	11.5%	13.2%	13.7%	14.2%	14.7%
NAIC 4	1.4%	4.5%	21.0%	23.0%	24.0%	24.5%	25.0%
NAIC 5	0.3%	10.0%	48.0%	48.5%	49.0%	49.5%	50.0%
NAIC 6	0.2%	30.0%	63.0%	64.0%	65.0%	66.0%	67.0%
Total (ex US Govt)	100.0%	1.3%	1.9%	2.5%	2.8%	3.0%	3.3%

AAM Insurance Investment Management

Given these changes, do we need to change our investment strategies?

- In the short term: **No**.
  - A.M. Best states they "do not expect sweeping ratings changes" and "the assumption is that current ratings are appropriate"
  - There is insufficient information to accurately judge how the new system will affect the relationship of investment risks to BCAR score
  - For BCAR and FSR purposes, the main focus for investment strategy should still be avoiding surplus losses while generating a reasonable return

- In the medium term: **Maybe.**
  - Over time it will become clearer whether/how much the factors will change for different investments. The relative attractiveness of these investments will likely change as a result and it may make sense to adjust the portfolio accordingly.
  - That said, if you are trying to achieve or maintain a specific rating, the best strategy is usually to communicate with your A.M. Best analyst and listen to what developments they are looking for.

Major changes are coming to A.M. Best's BCAR formula, including the use of sophisticated statistical modeling to calculate risk factors, and the presentation of 5 BCAR scores at different confidence intervals instead of a single one.

This should not cause ratings changes in the near term and we do not recommend modifying portfolios at this time, but once the new system is in place and the full impact is known it may make sense to make some adjustments going forward.

More information about the specific changes for Life/Health insurers is coming later this year.

As always, communication with A.M. Best is critical to understanding the factors that are determining your rating and that could cause it to change in the future.

A. M. Best's Methodology Update

"How Changes to BCAR will Impact Regulators' Opinions on your Society's Financial Condition"

Ken Frino
Group Vice President

09 September 2016
2016 Alliance Annual Meeting Workshop

Rating Methodology 2017

- Impetus for Change
- Building Block Approach
- Comment Feedback
- Rating Implications
- Questions

Impetus for Change

- Transparency & consistency
- A move towards best practices
- A way to integrate new tools
  - Application of BCAR

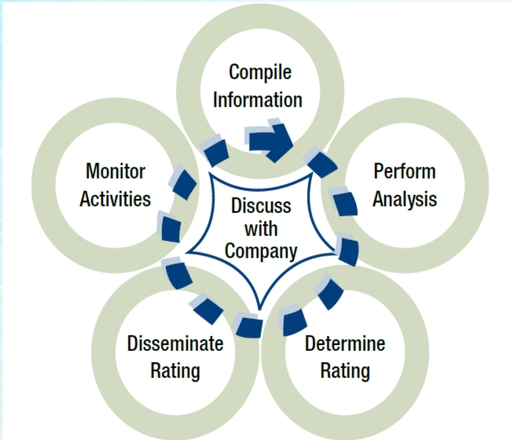
An Updated BCRM

The BCRM will be the key source document for deriving ratings

- Issuer Credit Ratings
- Financial Strength Ratings
- Issue Credit Ratings

An Updated BCRM

Not a fundamental change to rating analysis



An Updated BCRM

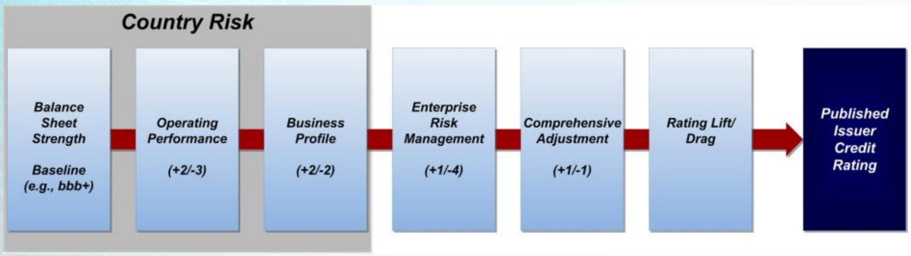
The BCRM is being updated but the fundamental rating drivers will remain the same

- Balance sheet strength
- Operating performance
- Business profile
- Enterprise risk management

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



The Building Block Approach Recap: Balance Sheet Strength

- Broken down into several parts
- Rating unit balance sheet strength assessment
  - – BCAR
  - – Internal capital models
  - – Other qualitative and quantitative factors
- Holding company impact
- Country risk impact

Stochastic Based BCAR

Best's Capital Adequacy Ratio (BCAR) is a comprehensive quantitative tool that evaluates many of the risks to the balance sheet simultaneously and generates an overall estimate of the required level of capital to support those risks and compares it with available capital

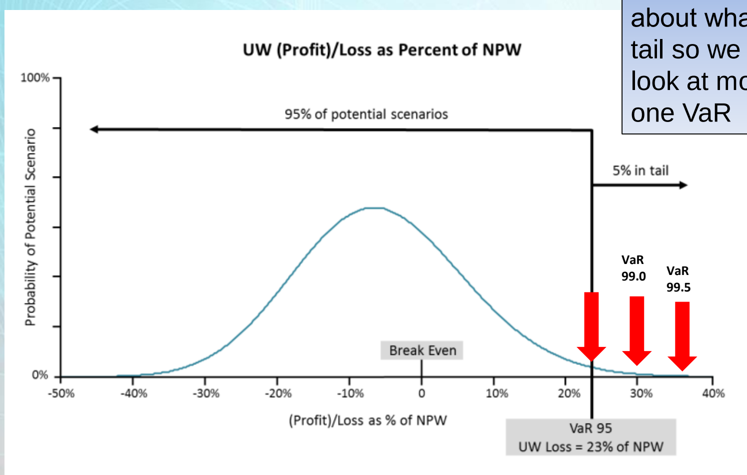
BCAR is a key tool in the assessment of balance sheet strength

- Not the sole determinant of balance sheet strength
- Not the sole determinant of the rating

Summary of Changes

- New Metric – VaR (Value at Risk)

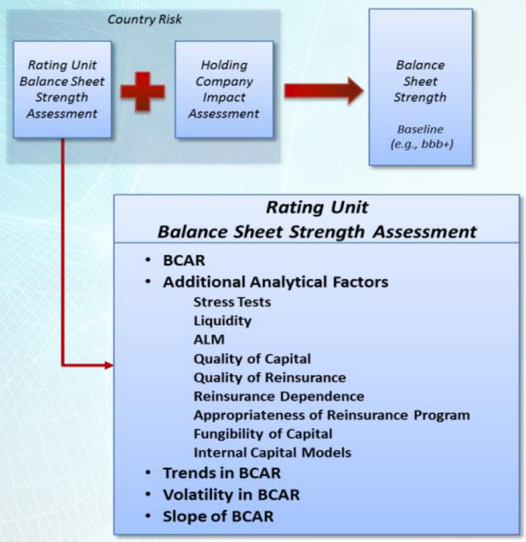
VaR does not tell us about what's in the tail so we need to look at more than one VaR



Summary of Changes

- 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

Applying BCAR Scores



Applying BCAR Scores

Country Risk

Rating Unit Balance Sheet Strength Assessment + *Holding Company Impact Assessment* → *Balance Sheet Strength*

Baseline (e.g., bbb+)

Rating Unit
Balance Sheet Strength Assessment =
"Adequate"

- **BCAR**
  Initial Indication = *"Strong"*
- **Additional Analytical Factors**
- **Trends in BCAR**
- **Volatility in BCAR**
- **Slope of BCAR**

The *Rating Unit Balance Sheet Assessment* reflects BCAR, all of the additional analytical factors, trends in BCAR, volatility in BCAR, and slope of BCAR.

Holding Company Impact Assessment

Country Risk

Rating Unit Balance Sheet Strength Assessment + ***Holding Company Impact Assessment*** → ***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 & 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 & Holding Company)

Lead Rating Unit	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

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 Recap: Operating Performance

- Underwriting performance
- Investment performance
- Total operating earnings
- Prospective financial forecasts
- Other considerations
- Unique to LOB, region of operation, structure

The Building Block Approach Recap: Operating 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

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 Building Block Approach Recap: 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 Building Block Approach Recap: ERM Analysis

- 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

The Building Block Approach Recap: ERM Analysis

A.M. BEST

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.

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Comprehensive Adjustment

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- Evaluation of key rating factors includes parameters which place limits on any one factor
- Recognizes 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.

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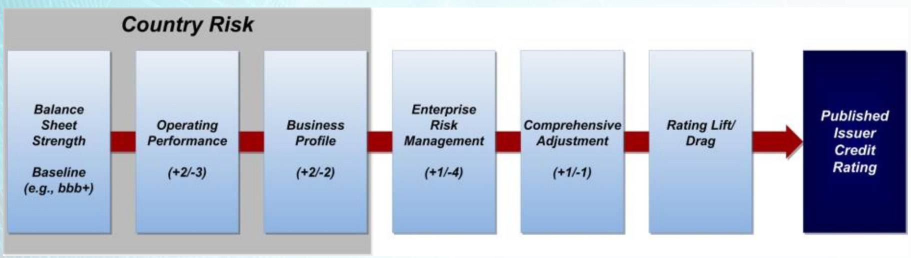
Lift/Drag

- Non-lead rating units may be eligible for partial rating enhancement 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 Lift/Drag	Adjustment (Notches)	Key Characteristics of Rating Lift/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



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
- Next criteria release will contain the following:
  - 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*

Rating Methodology 2017

- New criteria procedures/methodology are expected to go live in late 2017
- However, timing will depend on the quantity and depth of comments received
- Received a substantial amount of comments during the initial comment period
- Revisions to the BCAR and the BCRM are currently underway

Appendix

Comments

Type of Company (Dominant Business Line)	% of Comments Received
U.S. Property/Casualty	46.2%
Reinsurance	17.9%
International	12.8%
Non-Insurance	10.3%
Reinsurance Broker	7.7%
Other	5.1%

Comments

- Issued an update to the Call for Comment on May 5th
- Update was designed to encourage additional market feedback on use of models and understanding of BCRM
- Three specific questions were asked:
  - Do you fully understand the Building Block approach outlined in the BCRM and is it fully transparent?
  - Are there any parameters outlined for Balance Sheet Strength, Operating Performance, Business Profile, ERM, or Comprehensive Adjustment you disagree with?
  - What are your views on using VaR metrics for risk modeling in general? Do your views concerning the value of these metrics change as one goes out further into the tail (e.g. VaR 99.8 and 99.9)?

Comments

- Comments tended to focus on the BCAR
- BCRM generally seen as facilitating transparency though the building block approach
- Goal remains consistency and transparency
  - Currently considering areas where more visibility needed
  - Intend to add detail where questions have arisen

Comments

- In addition to the many comments focusing on the VaR levels, there were three items that received multiple mentions by formal commenters
  - –Including B8 (Catastrophe Risk) within the covariance adjustment
  - –The assumption that an interest rate shock would occur at the same time as an equivalent tail event
  - –The tax effected components of the BCAR

Changes Under Consideration: BCRM

- Providing additional clarity regarding the formation of rating units
- Making the ERM framework assessment more prominent via redesigning Risk Impact Worksheet (RIW)
  - Part I: ERM Framework
  - Part II: Insurance Risks
  - Part III: Overall ERM Assessment
- Including review of lower probability extreme tail events in ERM discussion

Changes Under Consideration: BCAR

- Considering the following changes
  - VaR levels
    - Issues of consistency and availability of data globally
    - Adding 99.6
    - Removing 99.8 and 99.9
  - Moving to stochastic-based factors as opposed to conducting stochastic modeling within the model itself

Rating Implications

- BCRM is NOT a means to change ratings although some ratings may change
- Analyst will communicate any potential rating issues 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