

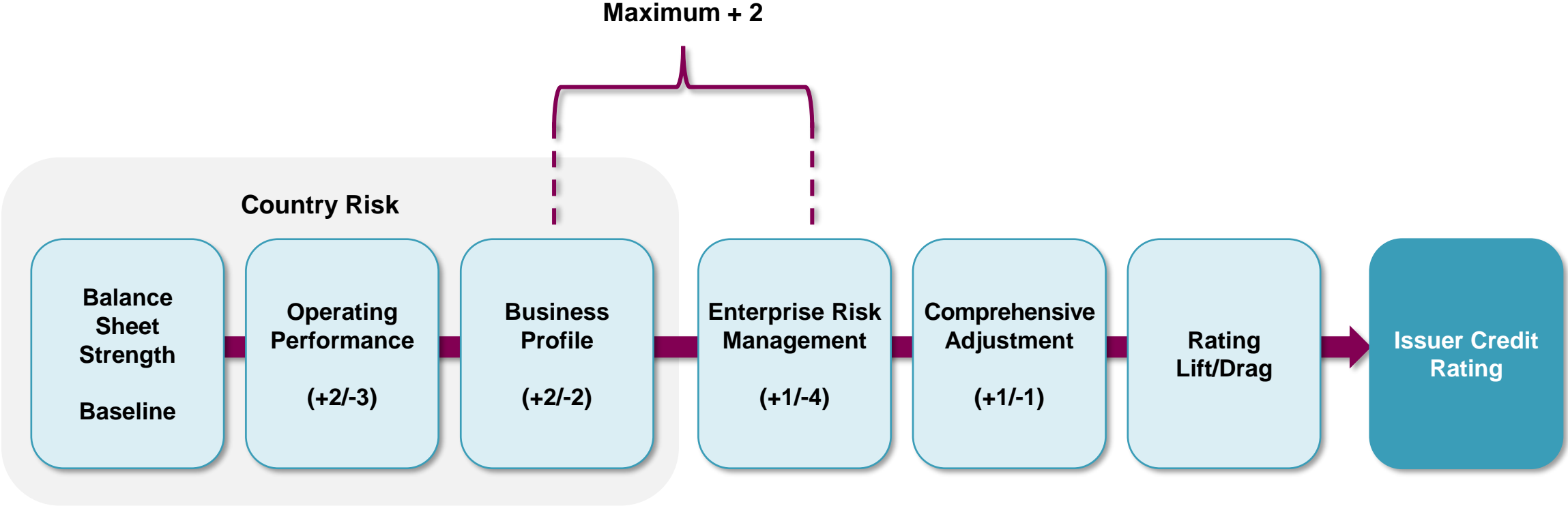
The Challenge of Assessing Capital Adequacy and Liquidity – A Rating Agency Perspective

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Balance Sheet Strength

- Balance Sheet Strength is the cornerstone of AM Best's rating process



Several Factors Drive Overall Balance Sheet Strength Assessment

- Risk-adjusted capitalization is one key component of evaluation of insurer's balance sheet strength
- Other key factors include:
 - Liquidity
 - Financial flexibility
 - Quality of capital
 - Impact of the holding company

Best Capital Adequacy Ratio (BCAR)

- Primary tool used by AM Best to assess an entity's risk adjusted capitalization
- Compares available capital to estimated required capital to support asset risk, credit risk, & underwriting risk at various confidence levels

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

Best Capital Adequacy Ratio (BCAR) Scores

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

Other Ways to Assess Capital Adequacy

**Traditional
leverage
ratios**

**Regulatory
view of capital**

**Internal
economic
capital models**

At What Level Do You Assess Capital?

- Consolidated view
 - Enterprise-wide view, based on consolidating financial statements
- “Rating unit” view (one or more companies)
 - Can reflect pooling agreements, intercompany reinsurance (easier to assess)
 - Can also reflect “Group” affiliation based on guarantees/net worth maintenance agreements, strategic importance (more difficult to assess)
- Individual Company view
- Where possible, AM Best completes a capital assessment on a rating unit level and enterprise-wide basis

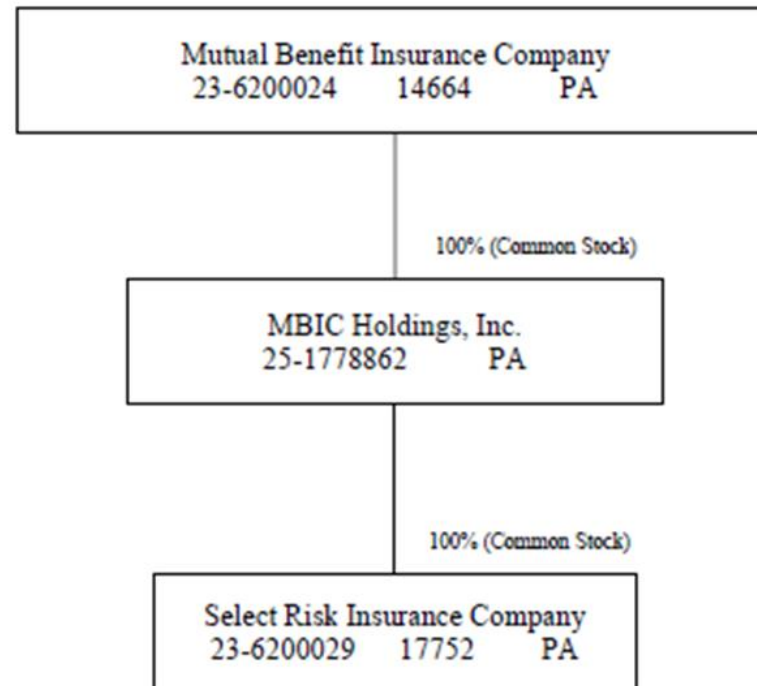
Key Considerations in Capital Evaluation

- Complexity of organizational structure
 - At what level does it make the most sense to evaluate capital?
- Ability and willingness to provide capital support if needed
 - Does the company have a track record of providing capital support when needed?
 - Is the entity or group important enough to assume it will receive support?
- Fungibility of capital
 - Regulatory or practical restrictions on capital movement?

Simple Structure – Example

ANNUAL STATEMENT FOR THE YEAR 2020 OF THE Mutual Benefit Insurance Company

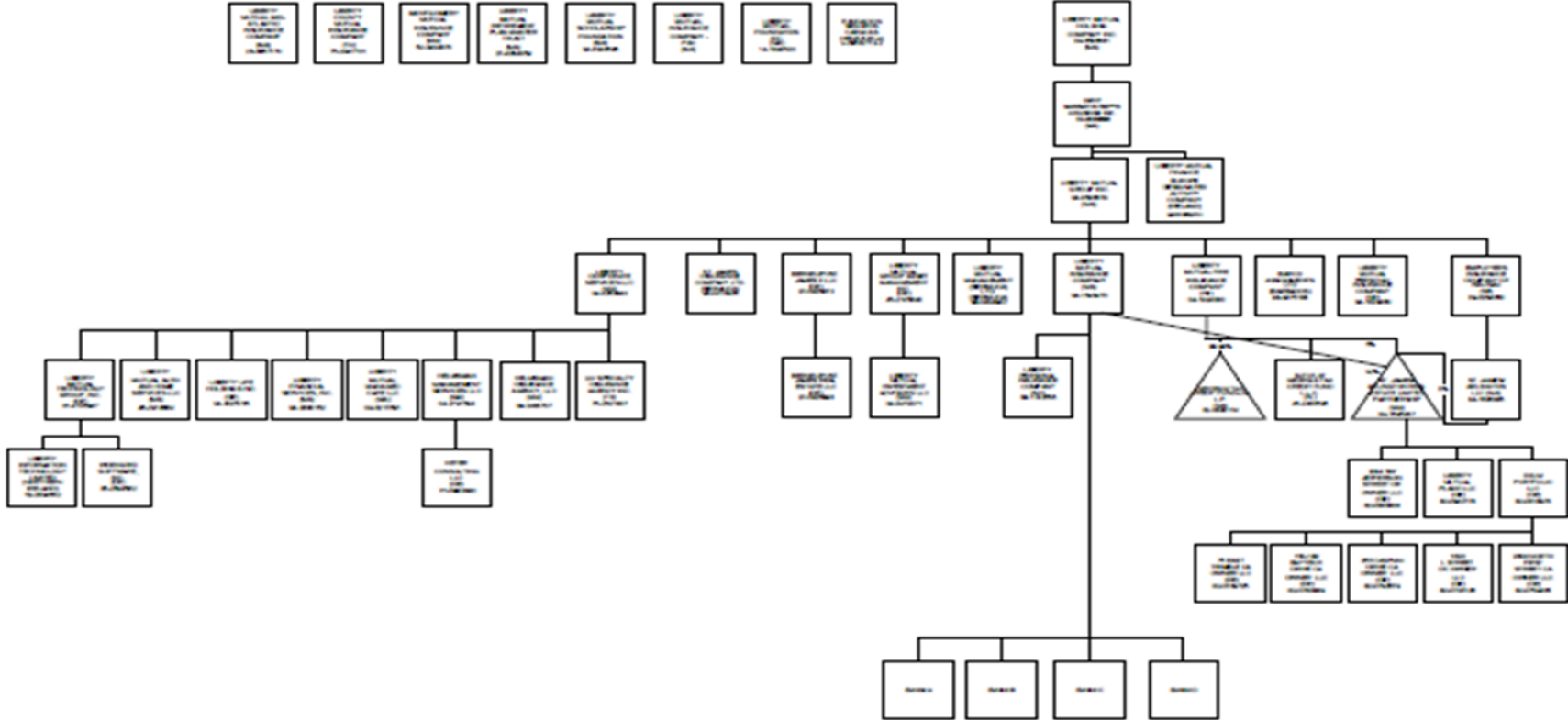
SCHEDULE Y - INFORMATION CONCERNING ACTIVITIES OF INSURER MEMBERS OF A HOLDING COMPANY GROUP PART 1 - ORGANIZATIONAL CHART



Complex Structure – Example

SCHEDULE Y - INFORMATION CONCERNING ACTIVITIES OF INSURER MEMBERS OF A HOLDING COMPANY GROUP

PART 1 - ORGANIZATIONAL CHART



Important Consideration Besides Capitalization

**Impact of the
holding
company**

Liquidity

**Financial
flexibility**

**Quality of
capital**

Holding Company Impact

	Very Negative	Negative	Neutral	Positive
Capital Assessment	<ul style="list-style-type: none"> • Poor financial flexibility • Weak quality of capital • High leverage in capital structure • Adjusted leverage > 65% 	<ul style="list-style-type: none"> • Limited financial flexibility • Reliance on soft capital • High double and/or operating leverage • Adjusted leverage 45% to 65% 	<ul style="list-style-type: none"> • Demonstrated financial flexibility • Moderate overall leverage • Limited impact from operating leverage • Adjusted leverage < 45% 	<ul style="list-style-type: none"> • Proven access to capital markets even during times of stress • High quality capital structure • Low levels of soft capital & intangibles • Adjusted leverage < 25%
Liquidity	<ul style="list-style-type: none"> • Poor liquidity management • Limited to no access to external liquidity sources 	<ul style="list-style-type: none"> • Elevated near term claims on cash • Access to external liquidity sources questionable 	<ul style="list-style-type: none"> • Laddered maturity schedule • Alternative liquidity readily available 	<ul style="list-style-type: none"> • Laddered maturity schedule • Strong liquidity management
Coverage	• Weak coverage < 2x	• Low coverage 2-3x	• Adequate coverage > 4x	• Strong coverage > 7x

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

Additional Holding Company Considerations

- Public vs. private (pros & cons)
- Cash held at holdco level
- LOC's, FHLB, Revolvers, Contingent Capital Facilities
- Potential contingent liabilities? (e.g. large legal settlements)
- Non-insurance businesses (pros & cons)
- Debt maturity schedules
- Risk-adjusted capitalization with/without credit for debt

Challenges/Yellow Flags

Limited financial flexibility

High proportion of illiquid investments

Complex organizational structures

Inability to generate organic capital growth

Aggressive financial policy

Questions?

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