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

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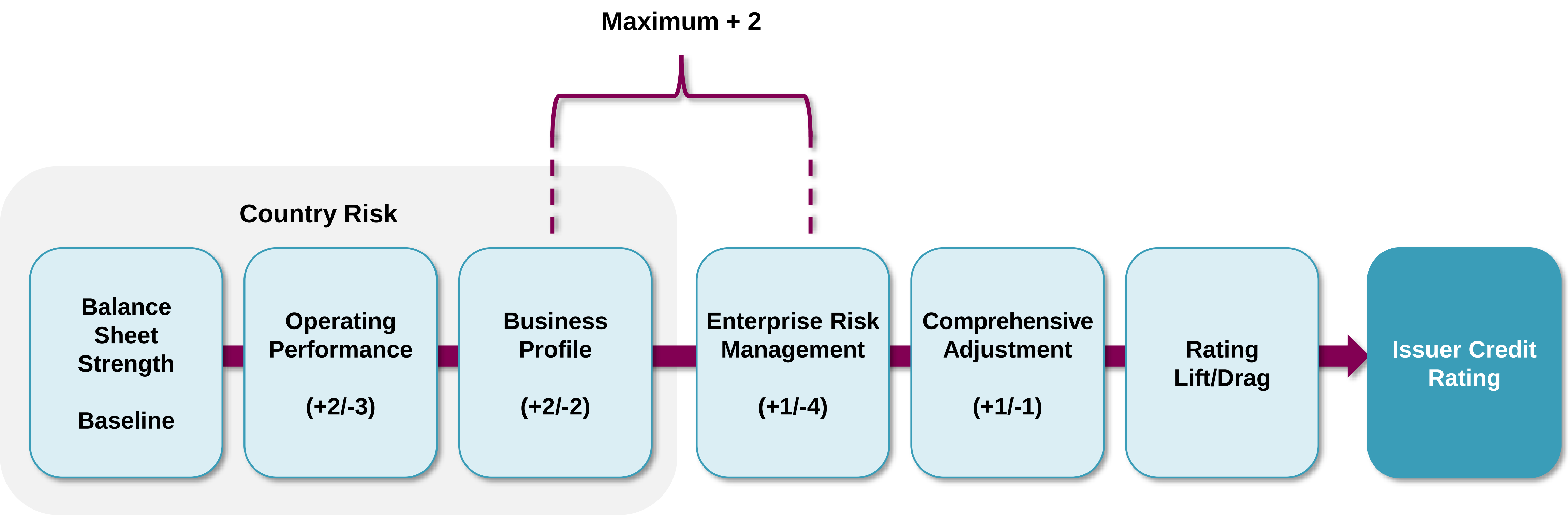
Balance Sheet Strength

- 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 rations

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?

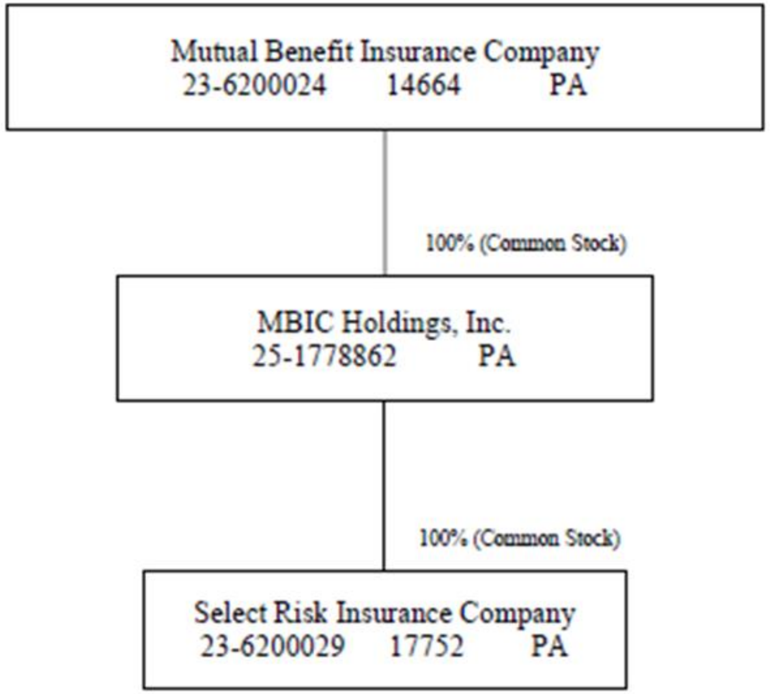
Simple Structure – Example

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

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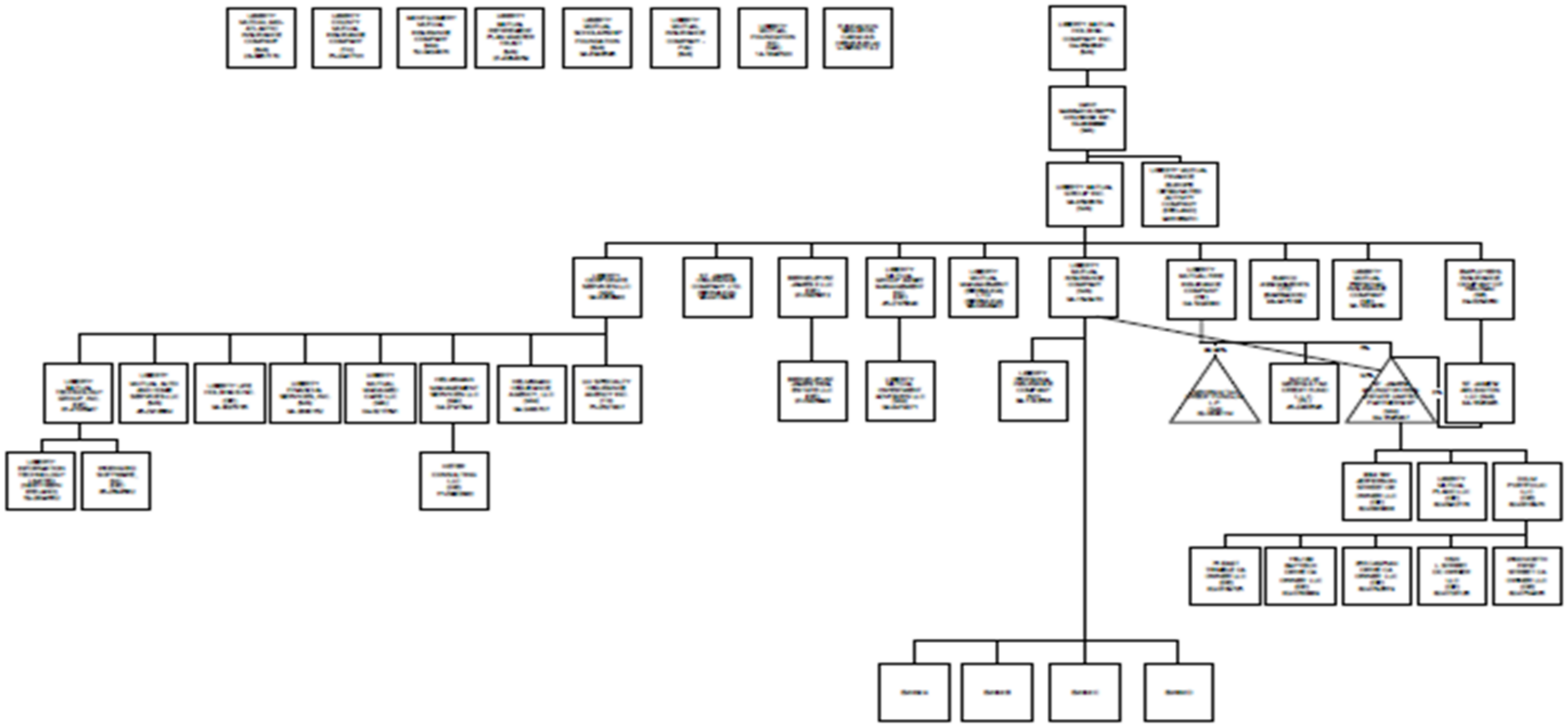

Important Consideration Besides Capitalization

- **Impact of the holding company**
- **Liquidity**
- **Financial flexibility**
- **Quality of capital**

Holding Company Impact

	Very Negative	Negative	Neutral	Positive
Capital Assessment	• Poor financial flexibility •Weak quality of capital •High leverage in capital structure •Adjusted leverage > 65%	•Limited financial flexibility •Reliance on soft capital •High double and/or operating leverage •Adjusted leverage 45% to 65%	•Demonstrated financial flexibility •Moderate overall leverage •Limited impact from operating leverage •Adjusted leverage < 45%	•Proven access to capital markets even during times of stress •High quality capital structure •Low levels of soft capital & intangibles • Adjusted leverage < 25%
Liquidity	•Poor liquidity management •Limited to no access to external liquidity sources	•Elevated near term claims on cash •Access to external liquidity sources questionable	•Laddered maturity schedule •Alternative liquidity readily available	•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?