AM Best Request for Comment Response: BCRM and Available Capital and Insurance Holding Company Analysis

On February 28, 2023, AM Best proposed revisions to Best's Credit Rating Methodology (BCRM) and Available Capital and Holding Company Analysis criteria procedure (renamed Available Capital and Insurance Holding Company Analysis). The request for comment (RFC) period for the methodology and criteria procedure closed on April 28, 2023. The methodology and criteria procedure are expected to be released for use on January 18, 2024. The revisions to the BCRM will result in a recalibration of a small portion of AM Best ratings, with less than 5% of published ratings affected. A review of the affected ratings will be completed within six months from the effective date of the revised methodology. The revisions to Available Capital and Insurance Holding Company Analysis criteria procedure will not result in any changes to any published ratings.

Revisions made to the final version of BCRM include the following:

- Newly developed AM Best classifications of insurance groups, largely determined by their regulatory environment, have been added to the criteria using the terms: Collective Capital Management Groups (CCMG) and Entity Prioritized Structures (EPS) along with an expanded discussion of prudential regulation
- Introduction of a new table (Exhibit B.2) to reflect narrower notching between Operating Company Issuer Credit Ratings (ICR) and Insurance Holding Company (IHC) ICRs for those groups classified as CCMGs
- Greater explanation provided on the treatment of groups operating across multiple jurisdictions
- Considerations for intermediate insurance holding companies
- Additional clarification provided for cases where an insurance group does not fit directly into a CCMG or an EPS category; as AM Best will consider the insurance group on a case-by-case basis with a review of its nature, scale and complexity. In the event a group remains not clearly classifiable in either of the two categories, EPS notching will likely be used
- Updated balance sheet assessment factors in Exhibit B.2: Rating Unit Review to ensure consistency with example in Exhibit B.5: BCAR Application

Updates on the criteria procedure, Available Capital and Insurance Holding Company Analysis focus on clarification and increased transparency. Revisions consider the latest capital structures, instruments and features inherent in the insurance market and include the following:

- Elaboration on the importance of issuer regulation for the treatment of debt in credit rating analysis
- Discussion of the treatment of downstreamed debt in Best's Capital Adequacy Ratio (BCAR)
- Explanation of how service-oriented activities are considered in the analysis of IHCs
- Clarification on the treatment of perpetual preferred shares
- Elaboration on certain instruments' features

- Expansion of Section C, under Hybrid Capital and Senior Debt in the BCAR, to consider issuer factors, including a portfolio view of issued instruments when assessing equity credit for individual debt issues in BCAR.

AM Best did not respond individually to comments submitted during the RFC period. A total of five (5) comments were received. For respondents who chose to remain anonymous, best efforts have been made to shield the identity of both the author and the company by redacting any text that could be used to identify the commenter. AM Best greatly appreciates the responses received during the public consultation period. Common themes, questions and comments on topics have been grouped into general responses. The following frequently asked questions (FAQs) address key themes resulting from public feedback and internal review.

FAQs

GENERAL

1. Why is AM Best making revisions to BCRM and Available Capital and Insurance Holding Company criteria procedure?

The revisions to the methodology and criteria procedure serve to provide transparency and clarifications to existing practices, recognizing and incorporating current market conditions and appropriately capturing the latest capital structures, instruments and other features used in insurance markets.

2. Will AM Best be including a full list of contents to ease navigation for the BCRM?

AM Best has included a contents page with hyperlinks to improve navigation within the BCRM.

3. What is an EPS?

An Entity Prioritized Structure (EPS) is an AM Best classification for insurance groups subject to an insurance prudential regulatory environment that may be focused on the regulation of each legal entity separately, with limited or no reference to effective jurisdiction over the IHC.

4. What characteristics does an EPS group have?

An EPS group has the following characteristics:

- The group's 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

5. **What is a CCMG?**

A Collective Capital Management Group (CCMG) is a classification for insurance groups subject to an insurance prudential regulatory environment that 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 other interests controlled by the group.

6. **What characteristics does a CCMG group have?**

A CCMG group has the following characteristics:

- The group's 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 the 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

7. **Are there only two forms of regulation?**

Regulation is generally comprised of two forms: group and entity regulation, with many jurisdictions having a mixture of both elements. Regulation is diverse and varied and an assessment of the overall effect of the regulatory environment encountered by a group across its footprint on capital management requires that it be considered on a case-by-case basis in our approach, alongside the group's corporate structure and management policy. AM Best does not categorize the different forms of national and supra-national regulation, but considers them as part of its assessment of the regulatory environment in place for a group. We appreciate that groups can be diverse and complex, covering multiple jurisdictions, so classification is not based on domicile, but rather is based on a case-by-case evaluation.

8. **Why is regulation considered in the assessment?**

Regulation plays an important role in how a group structures their operations, particularly for those that operate in many jurisdictions. Regulation, to some extent, will dictate the level of capital held within group operations and consequently, determine what this means for capital management, financial flexibility and capital fungibility across the group. Each group is viewed on a case-by-case basis with no list of jurisdictions that determine a CCMG or an EPS categorization.

9. **Is regulation only considered in the holding company evaluation?**

This discussion focusses on how regulation is factored into the IHC notching and analysis. AM Best considers aspects of regulation in many other areas of the assessment.

10. Is Europe classified as CCMG and the US as an EPS?

There is no set classification for making the determination of a CCMG or an EPS for groups substantially located in a particular jurisdiction; however, the regulatory priorities may infer that most insurance groups within the US are likely to be EPS and some large insurance groups in Europe are likely to be CCMGs. In all cases, an evaluation of the group's operations will need to be assessed to make any determination of notching from the operating entity to the non-operating insurance holding company.

11. Has there been any conversations with regulators on this subject?

In formulating the revisions to the methodology and criteria procedure, AM Best has engaged with regulators pre-and-post the consultation process. Feedback from regulators have been incorporated into the BCRM and Available Capital and Insurance Holding Company Analysis criteria procedure.

Best's Credit Rating Methodology

12. What type of companies are affected by revisions to Section IV of BCRM?

For the purposes of the revisions to BCRM, notching will only affect non-operating insurance holding companies. Companies or groups that bear insurance risks, such as, operating entities or operating holding companies are unaffected by the revisions.

13. What sections of BCRM are being revised and are there any changes to the core building blocks?

No changes have been made to the analysis of the core building blocks of balance sheet strength, operating performance, business profile, enterprise risk management and lift and drag. The main revisions relate to clarifications in Section IV: Insurance Holding Company and Issue Credit Ratings.

14. What impact will the revisions to BCRM have on credit ratings?

The revisions to the BCRM will result in a recalibration of a small portion of AM Best ratings, with less than 5% of published ratings being affected.

15. Is there a list of jurisdictions for CCMG and EPS classifications?

There is no list of jurisdictions for CCMG and EPS classifications. Groups and subgroups (consisting of a non-operating holding company and its operating subsidiaries) are classified on a case-by-case basis after reviewing the impact of regulation on the group or subgroup in the context of the group's corporate structure and management policy. Thus there is no automatic correspondence between head-office location, tax domicile or location of operations and a group's classification as a CCMG or EPS.

16. Has there been any change in AM Best's view on diversification?

Diversification has always been a consideration for the purpose of notching from the operating entity to the non-operating insurance holding company and continues to be an important component of the assessment. Credit has, and will continue to be given, to those groups that have demonstrated successful diversification of earnings from other sources of income that help generate additional income that support the activities and obligations at the insurance holding company.

17. Is there a default assignment to the EPS category?

In many cases, groups can be complex and operate in many jurisdictions. This means that it is important for AM Best to understand the regulatory environments under which a group operates, alongside their capital management policy. AM Best has adopted a flexible approach, with no one-size fits all view, reviewing groups on a case-by-case basis. In the event of cases where there are uncertainties or lack of clarity in determining the type of group that a particular non-operating holding company is part of, AM Best may move towards an EPS classification as the starting position for the purpose of (non-operating) IHC notching.

18. Is Bermuda classified as a CCMG or an EPS?

As described in the answer to question 15, there is no automatic correspondence between jurisdiction and a group's classification as a CCMG or EPS. AM Best expects to review Bermudian groups on a case-by-case basis in the same way as for all groups.

19. How will AM Best communicate whether a holding company is a CCMG or an EPS?

Where relevant and appropriate, AM Best will strive to provide transparency in its public communication, such as in credit reports, on the rationale for the insurance holding company notching.

20. Will non-operating insurance holding companies and their intermediate insurance holding companies in different jurisdictions receive the same notching?

Intermediate insurance holding companies in different jurisdictions may not receive the same level of notching as the insurance holding company. The relationship between the intermediate insurance holding company and the operating insurance subsidiaries is reviewed to assess whether the relevant sub-group is a CCMG or an EPS to determine the relevant notching.

21. **Will there be any impact on issue ratings?**

The notching for debt will remain as it is currently treated. In the small number of cases where the notching is narrowed for the non-operating insurance holding company, AM Best will need to consider any impact on any associated issue ratings.

22. **Is there an additional funding benefit for rated insurers operating without group supervision, for examples US Insurance Groups? Should the bandwidth for the highest ratings under EPS be notched 1-2 instead of 0-2 to further differentiate the notching between EPS and CCMG?**

The decision for notching and credit for debt is balanced and assessed on case-by-case basis. For those insurance groups that achieve the highest rating (“aaa”), there are exceptional strengths that should enable the group to meet its obligations, with the gap narrowing under both CCMG and EPS structures. At this rating level there may be less concern regarding access to capital and funding.

Available Capital and Insurance Holding Company

23. **Is AM Best changing its approach to senior and subordinate debt for BCAR and leverage purposes?**

There are no changes to the process and treatment of debt instruments for BCAR and leverage purposes. Revisions to criteria aim to provide clarifications and transparency in our approach, recognizing the latest developments in insurance markets.

24. **What impact will the revisions to Available Capital and Insurance Holding Company Analysis have on credit ratings?**

The revisions to Available Capital and Insurance Holding Company Analysis criteria procedure are not expected to result in any changes to any published ratings.

25. **Should subordinated capital be reviewed on a portfolio basis rather than an instrument-by-instrument basis?**

Within BCRM, AM Best’s considers the capital structure of the group and how the group would seek to support its operations through debt and equity. An additional comment has been added in Section C to provide increased clarity noting that AM Best considers issuer factors, including the group’s capital structure and the portfolio of issued instruments when reviewing the treatment of an individual instrument for BCAR purposes, and that these factors adjust the result of reviewing instrument features.

26. Will AM Best be improving clarity on the assumptions around published BCAR scores, such as clarity on credit given for senior debt?

Where relevant and appropriate, AM Best will strive to provide greater transparency in the calibration of the rating unit BCAR scores.

27. When is credit given for senior debt in BCAR?

AM Best generally gives credit for senior debt for Entity Prioritized Structures in the operating company BCAR assessment, where there is strong structural subordination and significant regulatory restrictions on the upstreaming of capital to the insurance holding company. The funds downstreamed to the operating entity must be recognized as capital by the regulator. Additionally, AM Best will calculate a BCAR on the insurance holding company, limiting the benefit of debt within BCAR to 20% of available capital. The BCAR assessment at the insurance holding company is a measure of whether there is any over-reliance on debt within the group's capital structure.

28. How much flexibility is given for capital credit for preferred shares?

AM Best has seen increased use of preference shares within capital structures. In exceptional cases, AM Best may grant full equity credit for BCAR and leverage purposes for those instruments that align closely to common equity. Each instrument would undergo a rigorous review of its features and characteristics. An example would be convertible perpetual preference shares, with no option to call (other than through the conversion to common equity), for which servicing places no more strain on the company than common equity dividend expectations.

29. Under what circumstances would AM Best give credit in BCAR above the 20% limit? Would AM Best give more credit for preference shares (closer to equity) than other forms of debt?

AM Best has made it clear that credit will only be granted to instruments that are closely aligned to equity. A full review of the terms and conditions of the instrument will need to be undertaken. For instruments that qualify, they will be treated as equity and not count towards the 20% limit as prescribed in criteria.

30. Are surplus notes considered in the Available Capital and Holding Company criteria procedure?

There is a separate criteria procedure that focuses on surplus notes, please refer to 'Evaluating US Surplus Notes'.

31. Does AM Best give credit for AT1 and RT1 instruments?

Additional Tier 1 (AT1) bonds are a category of bonds issued by banks and defined by bank regulators. As such, they are not relevant to the insurance sector. Restricted Tier 1 (RT1) bonds are a category of bonds issued by insurers defined in the EU's Solvency II regulations. AM Best considers regulatory classifications but conducts its own analysis of bond features to assess equity credit for leverage and BCAR. The analysis of bond features is conducted on an instrument-by-instrument basis and may be adjusted for issuer factors. RT1 bonds of sufficient duration would normally be given equity credit within the 20% limit.

32. How does AM Best consider significant non-insurance operations in its analysis?

A net asset value attributable to non-insurance operations may be part of available capital in BCAR in both the rating unit and holding company assessments, and also may be part of total capital in leverage calculations. AM Best will consider whether non-insurance activities might pose a financial risk as part of the stress testing of the rating unit and the consideration of financial flexibility/liquidity of the holding company. Value that may be inherent in non-insurance activities and the extent to which it might enhance an insurer's financial strength are considered as part of reviewing the quality of capital of a rating unit and the intangible assets of a holding company.

33. Provide examples of service-oriented activities?

Health services provided by operations that are part of a group which includes a health insurer are a typical example of service-oriented activities within insurance groups. Asset management activities are another example. Whilst these two examples have strong links to insurance, it is in principle also possible for an insurance group to own service-oriented activities that have little or no direct relevance to insurance.