[redacted]

From: Clare Finnegan <clare.finnegan@aon.com>
Sent: Friday, April 28, 2023 12:32 PM
To: Methodology Public
Cc: Enrico Leo
Subject: Public Comment
Attachments: Response to AMB_ ACIHCA and BCRM_Aon_April2023.pdf

Hello,

Please see attached comments from Aon re. the Request for Comment on the *BCRM* and *Available Capital and Insurance Holding Company Analysis* updates.

Best,

Clare

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

April 2023

Executive Summary

This document sets forth Aon's response to AM Best's request-for-comment (RFC) on its proposed revisions to its Best's Credit Rating Methodology and its criteria procedure Available Capital and Insurance Holding Company Analysis. We provide below our general view of the proposed changes. Our comments are based upon feedback from discussions with clients rated by AM Best across geographies.

Aon recognizes AM Best's objective to make periodic enhancements to its methodology and criteria procedures since its comprehensive update in 2017. Additionally, we support AM Best's objective of enhancing the transparency and consistency of its rating process. In general, Aon agrees that the proposed revisions to methodology meet this objective; we have identified areas where transparency could be even further enhanced.

Comments and Suggestions

Designation of Collective Capital Management Group (CCMG) Versus Entity Preferred Structure (EPS)

AM Best's acknowledgement of the importance of the regulatory regime in determining the appropriate notching difference between an operating company issuer credit rating (ICR) and an insurance holding company (IHC) ICR is consistent with market practice and adds clarity to the evaluation. Aon agrees that regulatory regimes and their accompanying structures often have a significant influence on an organization's capital management strategy. In certain regulatory environments a narrower notching between an operating company and a holding company may be appropriate given either the fungibility or lack of ring fencing of capital across entities.

However, for insurance groups with operations across many geographies and regulatory regimes, it may not be clear to market participants whether AM Best considers those insurance operations to be part of a CCMG or EPS. At some rating levels, the allowable notching between the operating company and either an EPS holding company or a CCMG holding company overlaps. For instance, for an operating company rated aa+ both an EPS holding company and a CCMG holding company could receive an IHC ICR of aa-. We suggest that AM Best clearly delineate in some manner whether a group is considered a CCMG or EPS, such as by noting this designation in the credit report.

Additionally, given the dynamics of the insurance marketplace, Aon can conceive of situations where an organization is currently considered a CCMG, but has projected that its operations in regulatory regimes that are more akin to an EPS evaluation may significantly increase in prominence over the medium-term. While Aon appreciates that AM Best intends to approach each situation on a case-by-case basis, the mechanism for re-evaluating the CCMG or EPS designation is somewhat unclear for companies projecting changes to their global footprint.

EPS and BCAR Capital Credit for Senior Debt

Aon agrees with the proposed treatment of capital credit for senior notes where there is strong structural subordination. In many cases, senior debt obligations are clearly subordinated to policyholder obligations both contractually and structurally and thus provide organizations with some degree of loss absorption and enhance the financial security of policyholders.

Aon notes that—given the global spread of certain insurance operations, along with AM Best's application of analytical judgement when making the CCMG or EPS designation—it may not be clear to market participants whether an organization's published BCAR score includes capital credit for senior debt. Aon suggests making this explicit in some manner in order to increase transparency.

Equity Credit for Preferred Shares

Aon agrees with AM Best's revision to grant full equity credit (not subject to AM Best's standard 20% limit) for instruments that are aligned to the features of common equity. However, Aon notes that the example cited by AM Best for receiving full equity credit—convertible perpetual preference shares with no call option—are a rarity and not representative of capital solutions available to a majority of companies. By citing such a restrictive example, Aon is unclear whether the criteria will actually allow for credit beyond the current 20% cap given the level of prescriptiveness. Additionally, for market clarity, Aon again suggests that should an entity receive full equity credit beyond the 20% limit in the BCAR evaluation that this be readily apparent.

Aon recommends that AM Best consider the use of a separate limit for preference shares that—when aggregated with the credit given to other instruments—would allow for total credit to exceed the standard 20% limit. Preference shares are more subordinated than other forms of hybrid capital and are more akin to equity; however, the proposed criteria (outside of the restrictive example above) does not differentiate between the BCAR credit given to preference shares and that given to other instruments, such as subordinated debt. This treatment is inconsistent with AM Best's financial leverage assessment where a differentiation is made, i.e., the use of the unadjusted and the adjusted financial leverage calculations. Like the leverage treatment, having a separate cap for preference shares in the BCAR calculation would acknowledge the heightened levels of financial flexibility demonstrated by companies that can access different forms and sources of capital.

Conclusion

Overall, Aon finds that the proposed changes provide the marketplace with enhanced understanding of AM Best's approach to analysing and rating insurance holding companies along with AM Best's determination of an organization's available capital. Aon believes our recommendations above support AM Best's goal of providing greater transparency to the marketplace.

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About Aon:

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[redacted]

From: [redacted]
Sent: Wednesday, April 12, 2023 10:21 AM
To: Methodology Anonymous
Cc: [redacted]
Subject: RfC response
Attachments: [redacted]

Dear Sir, Madam,

For your consideration attached please find the feedback from [redacted] to the Request for Comment on Best's Credit Rating methodology and the Available Capital and Insurance Holding Company Analysis, to be published anonymously. The National Rating Scale feedback has been submitted previously.

We look forward to an update on the rough expected timing of when responses and answers will be published, as well as when the final methodologies are expected to be published and effective.

Kind regards

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

Memorandum

April 12, 2023

To

AM Best

From

[redacted]

Cc

[redacted]

Subject

Comments in reply to the Request for Comment (RfC) on the Best's Credit Rating Methodology (BCRM) and the Available Capital and Insurance Holding Company Analysis

The response herein are to be published anonymously, sent via email to Methodology.Anonymous@ambest.com.

[redacted]

1. Best's Credit Rating Methodology (BCRM)

- A complete table of contents would be a welcome addition to support legibility and navigation of the document.
- Page 33 - The change in Exhibit B.2 Rating Unit Review (p33) to be closer to B.5 BCAR Application for ABC (p36) is unexpected, as this conflicts with the summary slide 6 stating that only section IV of the BCRM is updated. What is the intention behind the updated graphic, to show that the criteria considered for any rating unit as compared to an ABC are the same? Is there a reason Adequacy of Reserves and Reinsurance Dependence are only in B.5 and not B.2? The structure of the text no longer reflects these graphics. Please clarify.
    - Exhibit B.2 current BCRM published in 2020 includes: Consolidated BCAR, Financial Leverage, Operating Leverage, Coverage, Financial Flexibility / Liquidity, Intangible Assets, Non-Rated Affiliates.
    - Exhibit B.2 draft BCRM 2023 includes: BCAR, Stress Tests, Liquidity, ALM, Quality of Capital, Quality of Reinsurance, Appropriateness of Reinsurance Program, Fungibility of Capital, Internal Capital models
- Pages 88-94 (Part IV): We acknowledge and welcome the criteria enhancement offering more clarity for Entity Prioritized Structures and Collective Capital Management Groups. A limit and differentiated rating on senior debt that is pushed down as capital from a IHC to an operating entity is welcomed but still creates a significant funding benefit for insurers operating without group supervision (principally US insurance groups). If a IHC outside the regulatory ring fence falls into difficulties and is not able to service its senior debt, this may place significant pressure on the operating entities in terms of future access to capital and funding. Therefore, we suggest narrowing the notching bandwidth in Exhibit B.1 for AA from 0-2 to 1-2, to further differentiate the notching between Entity Prioritized Structures and Collective Capital Management Groups.

2. Available Capital and Insurance Holding Company Analysis

- A complete table of contents would be a welcome addition to support legibility and navigation of the document.
- Page 2 - In light of bank AT1 and insurance RT1 instruments being able to absorb losses in a going concern environment in conjunction with equity (e.g. when a bank's CET1 ratio falls below 7% or an insurer's Solvency Capital Ratio falls below 75-100%) strong consideration should be given to these instruments also being eligible for full equity credit. While such instruments are callable, in a stress scenario the market expectation is that the instrument will not be called either because refinancing costs are too high or regulatory approval would not be given, and, in a non-stress scenario, issuers should be allowed to determine the size of the AT1/RT1 portfolio by resizing it according to business needs in the same way as equity can be issued and repurchased, in some cases, without regulatory approval, to meet the business needs. Subordinated capital should, in our view, be viewed as a portfolio rather than on an instrument-by- instrument basis in the same way as equity is viewed as a portfolio. Servicing costs may also be cancelled on a non-cumulative basis whereas servicing costs on equity are variable but potentially accumulating.

[redacted]

To this effect, we suggest revising the second last paragraph as follows guidance

  - Revise 'For all instruments *viewed as a portfolio for a given entity or group*, a detailed review of their characteristics would need to be assessed to warrant equity credit'

- Page 3 – See response to the BCRM
- Page 5 – We would strongly encourage a closer look at bank AT1 and insurance RT1 instruments in the context of Exhibit B.1 as these instruments have the capacity to absorb losses with equity in a going concern stress (as distinct from the point of non-viability) e.g. when a bank's CET1 ratio falls below 7% or an insurer's Solvency Capital Ratio falls below 75-100%. See comments above regarding page 2. We suggest to revise Exhibit B.1 and the text to give consideration to RT1 instruments for equity credit.
- Page 10 – As mentioned in earlier comments, we believe subordinated capital should be viewed as a portfolio rather than on an instrument-by- instrument basis in the same way as equity is viewed as a portfolio. Equity may be issued and repurchased at different times and market expected returns on equity also rise and fall in line with the market conditions and the company's beta relative to those conditions. The same can be said of the portfolio of AT1/RT1 a bank/insurer has on its balance sheet. In addition, AT1 and RT1 instruments in particular have features that support the balance sheet more than equity in certain circumstances e.g. AT1 and RT1 requires regulatory approval to call in <u>all</u> cases whereas equity can be repurchased without regulatory approval provided the company remains well capitalised; AT1 and RT1 coupons may be cancelled on a non-cumulative basis whereas dividends on equity are arguably accumulating from period to period.

  To this effect, we suggest adding a sentence to the third last paragraph:

  - 'In addition, AM Best views instruments on a portfolio level, as they may be issued and repurchased at different times and are affected by the contemporary market conditions.'

- Page 22 – The new contingent capital section is welcomed.
- Pages 23-24 – For reasons similar to our earlier comments on AT1/RT1 being viewed as a portfolio, we believe that hybrid capital in the form of European insurance Tier 2 subordinated debt with cumulative interest deferral ("Insurance Tier 2"), should be viewed as a portfolio with less focus on the tenor of individual instruments. As with AT1/RT1 instruments, calling Insurance Tier 2 instruments is unlikely in a stress (replacement costs too high and/or regulatory disapproval) and outside of a stress the portfolio should be able to be re-sized in the same way as equity. Where an insurer is not in stress then it will be able rollover its Insurance Tier 2 instruments effectively making them a permanent part of the capital structure similar to equity, albeit with different loss absorption characteristics, which is reflected in the equity credit attributed to it.
- Page 24 – As mentioned in earlier comments, while a limit and differentiated rating on senior debt that is pushed down as capital from a IHC to an operating entity is welcomed, there is still a significant funding benefit for insurers operating without group supervision (principally US insurance groups). If a IHC outside the regulatory ring fence falls into difficulties and is not able to service its senior debt, this may place significant pressure on the operating entities in terms of future access to capital and funding.

[redacted]

From: [redacted]
Sent: Friday, April 28, 2023 4:21 PM
To: Methodology Anonymous
Cc: [redacted]
Subject: [redacted]
Attachments: [redacted] Comments to AM Best Proposed Revisons 4-28-2023.pdf

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Thank you very much for the opportunity to lend comments and suggestions to the proposed revisions.

We look forward to dialogue as A.M. Best moves forward with adoption and welcome any opportunity to discuss.

Many thanks,

[redacted]

[redacted]

April 28, 2023

A.M. Best Company
Ambest Road
Oldwick, NJ 08858
VIA: email Methodology.Anonymous@ambest.com

RE: [redacted] Comments on Proposed Revisions to Bests' Credit Rating Methodology (BCRM) and Available Capital and Insurance Holding Company Analysis

Thank you for the opportunity to review and provide comment on the proposed revisions to the A.M. Best Credit Rating Methodology (BCRM) and Available Capital and Insurance Holding Company Analysis. The consultation process provided by A.M. Best is welcomed by [redacted] looks forward to providing feedback that will generate additional discussion and clarity around the insurance company and holding company credit rating process. Additionally, we recognize and appreciate the additional time added to the comment period in order for industry to fully discuss the proposed changes.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

[redacted] has reviewed the documents and is pleased to provide comment to advance our mutual interests of having a robust, accurate, effective, and transparent credit rating mechanism that is properly focused on insurance companies and insurance holding companies without creating unintended bias or competitive advantage.

[redacted] COMMENTS -- A.M. BEST PROPOSED REVISIONS – BCRM

[redacted] closely analyzed the proposed revisions to the BCRM and determined that most significant changes are included in the determination of the Issuer Credit Rating (ICR) for insurance holding companies (IHCs) in the final ten pages of the BCRM document. Other proposed revisions were made and generally include positive or neutral clarifications to the model as noted in the February 28 press release.

Part IV Insurance Holding Company Credit Rating Proposed Revisions. The final pages of the proposed BCRM document address the methodology for developing the ICR for IHCs and the IR for any issuances from the IHC. Proposed new sections include “Regulation” and new categories of regulation including “Entity Prioritized Structures” and “Collective Capital Management Groups.” A.M. Best has clarified in recent presentations the intent that the Entity Prioritized Structures (EPS) are best represented by the regulatory system in the United States and the Collective Capital Management Groups are represented by Solvency II utilized in the EU and Canada. Using these regulatory distinctions, the draft proposes a new narrower notching protocol between operating entities and their IHCs if they are domiciled in jurisdictions with regulatory structures focused primarily on group supervision (like Solvency II). The draft describes Collective Capital Management regulatory systems as those having enhanced fungibility of capital, explicit financial obligations of the IHC enforced by the regulator, and more likelihood that excess capital is held higher up in the group structure. This change in focus from an IHC’s individual characteristics toward the regulatory system in which they are domiciled is of concern to [redacted]. [redacted] comments related to these changes are as follows:

I. **A.M. Best Should Rate Each IHC Based on Actual Capital Management Practice.** [redacted] proposes that a rated entity’s actual practice in capital management is more important to its IRC than how it is regulated. Since A.M. Best’s role is to rate operating entities and IHCs—not regulatory systems—this should be the focus of the revisions to the BCRM. [redacted] proposes the removal of these sections focused on binary definitions of regulatory systems and highly generalized categories of IHC structures. The existing language provides the flexibility to address differences in IHC capital management practices without indicating a preference between regulatory systems.

A. **There are more than two types of insurance regulation.** First, [redacted] suggests that regulatory systems don't fit neatly into these two buckets – entity-focused or group-focused. Since the financial crisis, many jurisdictions around the world turned their regulatory focus toward both operating entities and groups. These hybrid regulatory systems provide both strong group and operating entity supervision including requirements for the treatment of capital at both levels. Other jurisdictions with no domiciliary insurance groups remain focused only on operating entities. Including a binary approach to regulation in the rating of IHCs is inaccurate and incomplete. Ratings make most sense when considered in concert with each individual IHC's capital management system. The IRC assessment process for IHCs deserves more precision and nuance.

B. **Draft revisions recognize the need for individual assessment**. [redacted] notes that the proposed revisions suggest a couple of circumstances where A.M. Best concedes the need to look at individual IHC features despite the addition of these regulatory distinctions. First, language has been added stating that A.M. Best <u>may</u> decide that an IHC manages its capital as though they were regulated under group supervision and has the option to treat such IHCs accordingly. A.M. Best appears to recognize that IHC action must be approved by regulators in order to treat capital on a group level. While IHC's may be unique, the overall regulatory structure still applies unless permitted otherwise. However, this approach is not the practice for all IHCs and is applied only at A.M. Best's <u>option</u>, not for all IHCs. The recognition by A.M. Best of this possibility illustrates an understanding that each IHC is unique and not simply the product of its regulatory environment.

   Also, the draft revisions recognize that the significance of a group supervision regime is limited when the legal entities under the IHC are domiciled in a variety of countries with varying regulatory structures. The draft language provides that under such circumstances the IHCs may be treated as Entity Prioritized Structures, and notes that A.M. Best will need to undertake a thorough analysis of the organizational structure of international insurance groups with operating entities in numerous and varied regimes.

   These two noted distinctions in the treatment of IHCs emphasize the importance of unique treatment of each IHC even included in the language of the draft revisions. [redacted] proposes that there is no point in devising a general notching structure that differs between two types of regulatory supervision when it is clear that each IHC is unique and should be assessed accordingly.

C. **Expectations of IRC for Investors/Lenders.** Finally, investors and other organizations relying on the ICR are not asking A.M. Best to tell them how an IHC is <u>generally</u> regulated. They are seeking a precise, detailed assessment of the <u>unique</u> features of the IHC that illustrate strengths or weaknesses informing relationship decisions. Evaluating the unique IHC practice and structure is exactly what A.M. Best is expected to do in its rating process.

II. **Alternatively, Clarification of Strengths of Entity Prioritized Systems.** If A.M. Best persists in using an IHC's domiciliary regulatory system in establishing their IRC, [redacted] proposes that they clarify the full benefit of each system in the methodology. The proposed language implies that a group supervision approach is better and provides stronger connection between the IRC for the operating entities and their holding companies. This perceived value judgement in the methodology can add pressure on policy makers to revise legal and regulatory systems. It can also create competitive pressures on IHCs competing for capital in international markets. A.M Best should recognize in its process that an IHC may treat capital as group capital when agreements have been created between the operating entities and approved such that an IHC in an EPS is similar to the group supervision regulatory regimes.

In actuality, when the operating entities hold higher levels of excess capital, they will generally have higher ICRs than their counterparts in regimes where capital is held at the IHC level. At a minimum, this point should be included in the revisions to the methodology explaining the wider notching between the operating entity and the holding company under these regulatory systems. Adding a discussion about the general strength of the operating entities under an EPS regulatory system would diminish the negative impact of the proposed revisions related to regulatory structure.

[redacted] COMMENTS – OTHER REVISIONS TO BCRM FOR CONSIDERATION

The BCRM has been in use since 2019. [redacted] have felt its impact over the last three to four years. While the industry was told in 2017-2019 during the initial consultation process that the BRCM would not negatively impact most company ratings, such has not been the result for many small mutual companies. Since 2019 many of these companies were downgraded based on a rating methodology that did not reflect their value or financial strength.

Despite [redacted] comments and urgings, the BCRM was not modified to address the specific strengths of smaller mutual insurers, single state carriers, or niche market companies. The 2019 adoption of the BCRM failed to effectively weigh: A. The value of a company's longevity in the marketplace; B. The value of the simple (not complex) nature of their business; C. The financial strength that high levels of surplus reflects, D. The focused attention to fewer and typically more well-established distribution channels; and E. The knowledge of customers and the specific geographic or product risk they face.

As a result, the quest for better ratings has driven these companies to adopt practices that have increased expense ratios, especially fixed expenses and depressed operating results. The BCRM puts significant weight on product and geographic diversity, enterprise risk management, and innovation. While these attributes are powerful for large companies that can weather the pressure on expenses, many small companies with 25-100 employees (or less) cannot support the regulatory and marketing costs of operating in multiple states and the underwriting/product expertise required for multiple lines of insurance. They may not be well served to spend millions of dollars over multiple years on updated IT platforms and advanced marketing tools. In their effort to return to their previous A to A+ credit ratings, these companies may take actions that would actually diminish their surplus levels and damage their overall financial security.

These methodology changes were put into effect as insurers were dealing with a global pandemic, supply chain scarcity, unprecedented catastrophes, skyrocketing reinsurance costs, the highest inflation levels in 40 years, rapidly increasing interest rates and investment volatility. In such challenging times when stability and skilled management of known risks should have been the emphasis, many small mutuals have been trying to understand what changes A.M. Best wanted from them that would return their rating to the excellent levels they previously enjoyed.

The A.M. Best rating methodology should always provide the opportunity for strong and successful insurers to obtain the highest ratings. The role of a rating agency should be limited to reflecting the financial stability of the rated entities rather than incentivizing practices that may be best suited for large organizations. Smaller insurance companies have an important role in the market and the BCRM does not factor in the value and security those rated entities provide their policyholders and the insurance market. [redacted] encourages A.M. Best to consider methodological ways to recognize the scope and scale of insurance companies.

[redacted] COMMENTS – A.M. BEST PROPOSED REVISIONS -- AVAILABLE CAPITAL AND INSURANCE HOLDING COMPANY ANALYSIS

[redacted] closely analyzed the proposed revisions to the Available Capital and Insurance Holding Company Analysis and determined they primarily provide clarity regarding qualification for equity credit of non-equity instruments, limits for such credit and when no limit on credit is applicable. The proposed revisions include specific reference to "convertible perpetual preference securities (CPPS)" as qualifying for 100% equity credit subject to no limit. A new section on service-oriented activities under an IHC has also been proposed. In general, the proposed revisions are positive or neutral from [redacted] perspective. [redacted] comments related to these proposed revisions are as follows:

a. **Surplus Notes Treatment - Example Recommended.** In reviewing the draft [redacted] noted no reference to surplus notes as a form of security. The features of surplus notes are described but a clarification or example of the equity credit for surplus notes would be helpful to mutual insurers that rely on such instruments as a source of capital. Surplus notes often share the features described for CPPS.
b. **Service-oriented Definition.** More examples or a better definition of "service-oriented" activities is requested. [redacted] seeks to clarify if this term includes all non-insurance activities or some limited types of activities. [redacted] also requests clarification if a separate legal entity performing such activities is required.

[redacted] appreciates the opportunity to comment on the proposed revisions to the BCRM and the Available Capital and Insurance Holding Company Analysis. We hope continued dialogue and shared analysis will follow as A.M. Best moves forward with these methodological changes. If you have any questions about the [redacted] comments, please don't hesitate to contact me.

[redacted]

[redacted]

[redacted]

[redacted]

From: [redacted]
Sent: Tuesday, March 14, 2023 4:22 PM
To: Methodology Anonymous
Subject: Anonymous Comment

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Please add your comment

I am looking for clarity in the DRAFT BCRM:

1) For those insurance holding companies that have their notching lessened based on whether they are considered a Collective Capital Management Group, will any debt ratings also be notched off of the lessened notching and associated higher rating on the holding company?
2) Will information be provided on which jurisdictions and/or countries will be Entity Prioritized Structures and which will be Collective Capital Management Groups based on the insurance prudential regulatory environment?

Thank you.

[redacted]