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NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

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June 30, 2016

A.M. Best Company
Ambest Road
Oldwick, NJ 08858
VIA: methodology.commentary@ambest.com

RE: NAMIC formal comments on proposed revisions to Bests' Credit Rating Methodology (BCRM) and Best's Capital Adequacy Ratio (BCAR)

Dear Stephen Irwin, Thomas Mount and Matt Mosher:

Thank you so much for the opportunity to review and provide comment on the proposed changes to the A.M. Best Credit Rating Methodology (BCRM) and Capital Adequacy Ratio (BCAR). NAMIC represents a diverse spectrum of insurers that rely on insurance credit ratings used for many purposes including reinsurance, regulatory, lending and government programs. Consequently, NAMIC has a significant interest in the practices for rating member companies and the measurement methodology used by A.M. Best to develop the factors that are used in the rating process.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 39 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies serve more than 170 million policyholders and write more than $230 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets. Through our advocacy programs we promote public policy solutions that benefit NAMIC member companies and the policyholders they serve and foster greater understanding and recognition of the unique alignment of interests between management and policyholders of mutual companies.

We have reviewed the documents and are pleased to provide comment in order to help advance our mutual interests of having a robust, accurate, effective and transparent credit rating mechanism that is focused on insurance companies and insurance groups.

NAMIC COMMENTS - EXECUTIVE SUMMARY

NAMIC has a wide range of members from the smallest farm mutuals to the very largest mutuals, reciprocals and stock members. Our members are primarily mutual insurers so concerns about the treatment of mutuals will be the focus of our remarks. In addition, among our membership we have over 500 members that operate in a single state, 100 or so that consider themselves niche writers and approximately 40 who write a single line of business. We hope that the information we provide A.M. Best will help to explain our various members' issues and will be helpful to all concerned.

The proposed revisions to the BCRM and BCAR systems have been evolving over the last couple of years. NAMIC appreciates the transparent nature of the discussions, the frequent webinars and Q and A sessions offered and the individual company analysis tools A.M. Best has provided for the industry related to these changes. Several revisions and improvements in response to industry have been made by A.M. Best already that will ease the transition and improve the accuracy of the methodology. We specifically welcome the proposal of May 5, 2016 not to utilize the 99.8% and 99.9% VaR levels in determining the Balance Sheet Strength Assessment. Once finalized, this proposed change could alleviate the most critical concerns for many of our members. The remaining issues for NAMIC members include the redundancy of the criteria that affect NAMIC members, the subjectivity in the notching, and technical questions related to investment risk assessment, VaR metrics/stochastic modeling and catastrophe risk treatment.

NAMIC's specific concerns and recommendations are as follows:

- Concern: There is an unintended downward impact of the proposed rating process on mutual companies in general and single state and niche insurers in particular.
    - NAMIC recommends changes to the BCAR calculations to allow positive notching, or higher Balance Sheet Strength Assessment ratings, for firms that are capitalized more than 500% of NAIC RBC requirements.
    - The duplication of positive notching credit for sophisticated modeling should be replaced with an outcomes-based analysis to determine if the company, based on its own risk profile, is successfully managing its enterprise risk appropriate to the nature, scope and complexity of its enterprise.
    - NAMIC recommends A.M. Best consider additional factors to offset lack of diversity like company longevity in the geographic/niche market, low customer turnover, stability of distribution channel and its fitness for the purpose of serving the carrier's customer population.
    - NAMIC encourages A.M. Best to develop the most appropriate benchmarks for rating including those that reflect mutual company strengths. Maintaining the best stock and mutual criteria for benchmarking would provide the best unbiased results.
- Concern: The process, as set forth in the proposal, seems to provide subjective authority to the A.M. Best analyst to downgrade companies with less range for upgrades to companies.
    - NAMIC recommends including more detail in the methodology description reflecting the internal and external checks and balances A.M. Best applies to manage the subjectivity of the analyst's judgment.
    - NAMIC recommends reconsidering the levels of subjective judgment an A.M. Best analyst can use in the rating process.
- Finally, we have some technical issues/questions including:
    - Concern: The use of identical investment risk factors for Life and P/C insurers is not appropriate due to distinct differences in business models;
        - NAMIC proposes that A.M. Best conduct risk analysis and risk weighting for various investments that would be appropriate for companies that only operate in a property-casualty environment and perhaps even for multi-line companies.
    - Concern: Should the methodology use VaR metrics and stochastic modeling proposed to develop P/C risks?
        - NAMIC agrees with the A.M. Best suggestion in the May 5, 2016 update that confidence intervals of 99.8% and 99.9% VaR be eliminated from the

balance sheet strength assessment. We also suggest that any information collected at these confidence intervals should remain confidential and not be published in any A.M. Best public reports or databases.
    - NAMIC agrees that stochastic modeling is more often a tool of the ERM analysis and may be more appropriate in that context for the BCRM. NAMIC supports the use of stochastic modeling on a company by company basis but recommends recognition that such modeling is not determinative of the ERM scoring.
  - Concern: NAMIC suggests changes to the enhanced emphasis on catastrophe risk in the proposed process.
    - NAMIC recommends consistency with actuarial practice that would suggest the adjustment of catastrophe risk by the covariance calculation.

NAMIC is pleased with the transparency of the A.M. Best proposed revisions to the BCRM methodology. The review process provided has been informative. The comment opportunity is a welcome approach considering the significance of the changes. NAMIC remains willing to assist with any further improvements to the credit rating process.

NAMIC COMMENTS -- A.M. BEST PROPOSED REVISIONS

General Issues

A. Downward Impact of Proposed Rating Process on Mutual Single State/Niche Companies

Mutual insurers that operate in a single state often provide coverage for risks that are similar in many ways to more urban risks but are remote in location, insignificant in market size or so dispersed that larger carriers do not address their needs. This was the model of many new mutual insurers during their emergence in the 1800's and 1900's. These visionaries who started such insurance companies provided a ready market for these rural policyholders whose needs were either unmet by large carriers or who were being unfairly charged the same premiums as policyholders in much more congested, risky communities. The growth of this rural mutual industry marked the birth of significant changes in insurance rating and underwriting practices, including recognition of risk relativities between territories smaller than states, creation of unique policy language designed to address unique needs and the development of multiple criteria for the evaluation of risks.

Similarly mutual insurers operating in niche markets provide insurance products for unique industries. By developing a level of understanding of those industries they can provide tailored risk management tools, tailored underwriting/claims handling, and tailored insurance products/premiums to address real needs and leverage a knowledge advantage over general insurers. The niche carriers over time have brought the concept of specific industry-customized underwriting, claims handling, loss control and pricing to all commercial insurers, but continue to bring the best services to the niche markets they serve. Mutual single state and niche insurers have shown over time to be innovators in insurance and while some have grown to extraordinary size many have thrived for decades continuing to improve their products and services for the special focused markets they set out to serve when they were originally organized.

While these single state and niche carriers may not have the diversification that a large, complex carrier has, neither do they have the unknown risks and management challenges that complexity and diversification can unexpectedly and disastrously (*e.g.* AIG) bring to a multi-jurisdictional carrier. Granted small and niche carriers can be poorly managed, as is true with a carrier of any size or geographic scope, but the proposed A.M. Best BCAR and BCRM criteria appear to have a bias that will produce downward rating pressure for these specialty-focused companies in the industry.

Unfortunately the proposed criteria will create a greater potential for smaller specialty companies to suffer rating downgrades despite strong financial performance, years of successful operation, effective management and first-rate competence in their marketplace. The proposed criteria will place rating pressure on companies that exhibit:

- lack of diversification across many company features – product writings, loss reserves, geography, assets, production sources and reinsurers;
- limits on their ability to raise capital as mutuals;
- perceived immaturity of ERM practices;
- perceived lack of pricing sophistication; and
- volatility of results – which is inherent with smaller companies.

At the same time the methodology does not take into account the value of a company's longevity in the marketplace, the simple (not complex) nature of their business, their knowledge of their customers, the geographic or product risk they face, the very high levels of surplus some mutuals carry to offset capital concerns, the focused attention to fewer and typically more well established distribution channels. In addition, the A.M. Best criteria directs little attention to the over-reliance of an insurer on economic capital models that <u>do not work</u>, as witnessed by the failure during the financial crisis of companies with sophisticated pricing and capital models.

Based on our understanding of the proposed BCRM, the highest rating a typical single state NAMIC member company can initially obtain under the Balance Sheet Strength Assessment is an Issuer Credit Rating of "a+". The rating is then "notched" for Operating Performance – which for many smaller companies in our membership may well be limited to one notch. This would adjust the ICR rating to "aa-". The next assessment is Business Profile and again, many companies in our membership would probably be notched down one level due to single state focus. This would adjust the ICR rating to "a+". The final assessment is ERM. We assume most of our members will be able to demonstrate adequate ERM for their business risks which would result in no notching to the rating. So regardless of how strong and reputable a NAMIC member company is in their region and regardless of their longevity as an insurer for over 100 years, the highest rating they could realistically achieve is a Financial Strength Rating of "A". We suspect many of our member companies may start with an initial Balance Sheet Assessment ICR rating of "a" which would limit them to a Financial Strength Rating of "A-" despite decades of successful operations.

The possibility of duplicative downward notching and the minimal upward notches available should be addressed in the final version of the methodology. The A.M. Best criteria should provide the opportunity for strong and successful NAMIC members to obtain the highest ratings. As it is currently designed and calibrated, we suspect many will lose their "A" and "A+" Financial Strength Ratings.

Recommendations: NAMIC believes that A.M. Best did not change the criteria to indicate a negative view of or credit rating issue with mutual single state and niche companies, but these are the potential unintended consequences. We recommend that adjustments to the criteria to recognize the values represented by this segment of the industry and the potential balance between the values that diversified, complex companies offer would be an improvement in the criteria that would reflect the actual performance of companies. Suggestions we have for such revisions are as follows:

- *BCAR – Rewards for High Capitalization*: NAMIC recommends changes to the BCAR calculations to allow positive notching, or higher Balance Sheet Strength Assessment ratings, for firms that are capitalized more than 500% of NAIC RBC requirements. This would allow for these companies to offset the negative implications of the mutual structure with the positive realization that mutual insurers generally hold higher levels of capital than non-mutuals.

- *BCAR and Enterprise Risk Management (ERM) – Reduce Overemphasis on Modeling*: NAMIC notes that both the BCAR balance sheet strength assessment and the ERM criteria consider the sophistication of the economic/internal capital modeling developed by a company. This applies a redundant upgrade for companies exhibiting extensive capital modeling process that we believe will unfairly disadvantage mutuals, single state and niche companies. While some of these entities use more sophisticated modeling, the more important issue to focus on is the company's outcomes and performance. Is the company really appropriately managing, mitigating, transferring, and estimating/identifying its risks? On an outcomes-basis, is the entity successful in their risk management of all their risks, tolerances, factors and possible events? Overreliance on a sophisticated model without the overlay of sound reasoning, proper assumptions and identification of missing elements is not only unhelpful, it can be its own distinct risk by creating a false level of confidence. It is not the model that makes the company successful in ERM; it is the attention to the details and critical review of the entire program by the leadership team and ERM professionals. Small mutuals, single state and niche companies can have successful ERM programs without complex technology and should be reviewed for their results, not the technology they employ. The duplication of credit for sophisticated modeling should be eliminated and replaced with an outcomes-based analysis to determine if the company, based on its own risk profile, is successfully managing its enterprise risk appropriate to the nature, scope and complexity of its enterprise.

- *Business Profile – Balance Diversification with Simplicity:* The diversification of a company is significantly rewarded in this element of the BCRM process. Diversification of product or geographic scope and diversification of distribution channels are all viewed favorably under the criteria. There is no consideration of the <u>complexity</u> that selling multiple products, operating under different state/country laws or managing the sales efforts of varying distribution channels can bring to a company. While there is value in assuring that a company has options and will not become insolvent because of a single product, regulatory decision or distribution channel, there is also value in simplicity that is not recognized in the proposed credit rating process.

A company that has operated in the same geographic area or served the same niche market for over 100 years, with minimal customer turnover, with distribution channels that suit those customers and operate in that geographic area or niche market, is not rewarded under the formula. Such a company will have significantly more: 1) specific knowledge of its customers and the risks each pose; 2) knowledge of the products they write; and 3) experience with the risks and claims related to the geographic area or niche business.

In the A.M. Best proposed revisions there are no credits provided for this unique knowledge set. Companies that do not have significant diversification may balance that weakness with such knowledge and experience. NAMIC suggests that the benefits of a smaller or less diversified organization should at least protect against negative notching for lack of diversification in the methodology. If not properly addressed, this implied rating pressure for "lack of diversification" will prompt many companies to engage in "diversifying" to achieve future rating benefit – which if not done properly could lead to financial instability.

One approach is to continue crediting companies with diversity as set forth in the proposed methodology, but for non-diversified companies, before downgrading them, examine additional metrics that may offset their lack of diversification. The following are some additional metrics for consideration: company longevity in the geographic market, low customer turnover, size of the market, stability of distribution channel and its fitness for the purpose of serving the carrier's target customers. If these factors or other factors could be used to justify similar upward notching for those non-diverse carriers it could provide a more accurate view of the credit risk of the organization.

B. Subjective Authority -- BCAR Results and BCRM Notching

The revision discussions related to the BCAR and BCRM have revealed a great deal about the criteria and the thought process of A.M. Best analysts. The transparency of the process and the frequency of the discussions with interested parties are very welcome. Despite this transparency there remain some unknowns in the rating process. On the face of the proposal the apparent analyst discretion within the methodology can mean the difference between a very strong score and a much weaker score for an organization. This discretion is notable in the BCRM Exhibit A.6 showing the range of balance sheet strength assessments available to the analyst. The balance sheet strength is the baseline for the whole analysis and, therefore, a significant element of the methodology.

From reviewing the proposed BCRM it seems analysts have significant authority to apply subjective downward and upward notching. This subjectivity in the process has to be carefully controlled and managed to protect the validity and/or reputation of the rating system. This is especially noteworthy since the downward notching range is greater than the upward notching range, and there is not a clear definition of the objective reasons and/or calibration for supporting the notching. We suggest that additional information about the specific internal processes A.M. Best employs before finally adopting any analyst's recommendations for notching would be a valuable addition to the methodology.

Recommendation: NAMIC raises this issue based on the information provided in the proposed methodology and not based on the experiences of rated companies. If A.M. Best actually requires

more objective information from an analyst to determine the balance sheet strength assessment and apply notching, then we recommend an amendment to the BCRM to include a more specific notching guideline. This revision would provide a great deal more transparency in the criteria and would support soundness of the rating process.

Technical Questions

A. **Identical Investment Risk Factors for Life and P/C insurers**

Under the proposed revisions is it not clear if there will be differences in the analysis of investment risk for life and property-casualty companies. This issue has arisen in numerous discussions with the NAIC and with regulators. Our position is that while the particular investments viewed in isolation may seem to carry the same risk regardless of whether held by a life or property-casualty company, the goals of particular investment strategies and portfolio diversifications are not the same. Under a life business model the goal is to achieve accurate asset-liability matching for long term products. Under a property-casualty business model the goal of capital is strength of policyholder surplus, liquidity and keeping pace with inflation (claim costs are significantly impacted by inflation – *e.g.* medical costs, construction costs, and auto repair prices). Life insurers generally have fixed future liabilities based on policy limits, but property-casualty insurers' future claims will vary significantly depending on catastrophic and inflationary forces. As a result of the differences in investment goals, property-casualty insurers are more heavily invested in municipal bonds, treasuries and common stock which offer greater liquidity and a hedge against inflation and life insurers are more heavily invested in corporate bonds and mortgage investments that match the terms of their liabilities.

The differences in business models are reflected in the NAIC RBC analysis as well. There are differences in the way that life and property-casualty companies report realized investment capital gains/losses that are based on statutory accounting principles. Life companies are required to establish asset valuation reserves (AVR) as a direct charge to surplus to offset potential credit-related investment losses on all invested asset categories. Life companies are also required to use an Interest Maintenance Reserve (IMR) for all types of fixed income investments, to capture all of the realized capital gains and losses which result from changes in the overall level of interest rates as they occur. Once captured, these capital gains or losses are amortized into income over the remaining life of the investments sold. In addition to these accounting differences, the RBC formula inputs include differences in tax treatment between life and non-life investments. Neither AVR nor IMR are utilized in the property-casualty reporting. This illustrates the significant differences in life and non-life investments reporting that support different treatment of investment risks.

Finally, there is a critical difference in the actuarial importance of investment risk between life and property-casualty insurers. For purposes of RBC, property-casualty actuaries put far more importance on the premium and reserve risks than they do on investment risk. The success of property-casualty companies is more dependent on their rating, underwriting and claim performance than their investment performance, while this may be relatively less true for life insurers.

Recommendations: These differences may or may not be addressed in the A.M Best methodology, but we wanted to be sure you were aware of the significance of the differences. We recommend that different risk analysis and risk weighting for various investments would be

appropriate for companies that only operate in a property-casualty environment and even for multi-line companies. If there is interest in further discussions around this issue we will be happy to work with A.M. Best to identify the appropriate investment risk analysis.

B. VaR Metrics and Stochastic Modeling

The proposed revisions originally included assessment risks on a VaR basis including 1:500 and 1:1000 return periods with confidence levels up to 99.9%. In the May 5, 2016 "Update to Best's Credit Rating Methodology and BCAR Call for Comment," revisions were proposed based on comments already received that will have a drastic impact on the capital requirement proposal. NAMIC favors the elimination of the confidence intervals of 99.8% and 99.9% VaR from the balance sheet assessment. At these very high levels of confidence we agree with the A.M. Best May 5 update that the information is less accurate, more volatile and more sensitive to assumption errors. These limitations are especially true in the global context.

Exhibit 1 - BCAR Index for NAMIC
Guy Carpenter & Company LLC

		Average of Stochastic BCAR Score					
	Number of Cos.	1:20 VaR 95.0 [<= B]	1:100 VaR 99.0 [B++/B+]	1:200 VaR 99.5 [B++/A-]	1:250 VaR 99.6 [A/A-]	1:500 VaR 99.8	1:1000 VaR 99.9
Composite of 92 Mut Cos	**92**	**67.2%**	**54.0%**	**40.6%**	**31.0%**	**8.6%**	**-23.5%**
Central/Midwest	29	67.5%	53.2%	47.2%	43.9%	36.4%	24.0%
Gulf/Southeast	5	76.7%	64.7%	57.1%	45.8%	19.4%	-26.3%
Mid-Atlantic/New England	38	73.2%	58.6%	34.9%	17.7%	-22.4%	-77.8%
Pacific/Mountain	6	61.3%	51.2%	45.4%	39.8%	26.7%	5.1%
National	14	49.8%	40.3%	34.6%	31.4%	23.9%	14.2%
"A+" Rated Companies	12	77.5%	66.4%	52.7%	41.6%	15.8%	-19.0%
"A" Rated Companies	33	70.8%	58.6%	50.7%	43.7%	27.3%	4.1%
"A-" Rated Companies	31	63.0%	48.3%	29.7%	18.0%	-9.1%	-44.1%
"B++" Rated Companies	10	68.1%	52.2%	33.0%	19.7%	-11.2%	-70.9%
"B+" Rated Companies	4	58.2%	45.1%	38.9%	34.2%	23.4%	7.8%
"B" Rated Companies	1	55.4%	35.2%	25.7%	19.9%	6.4%	-20.3%
Commercial Casualty	16	60.6%	47.9%	40.9%	35.1%	21.5%	0.9%
Commercial Property	6	57.6%	43.7%	32.1%	25.5%	10.3%	-7.7%
Personal Property	28	72.9%	58.8%	37.0%	21.7%	-14.0%	-63.9%
Private Passenger NSA	1	62.2%	43.8%	36.7%	33.9%	27.5%	20.2%
Private Passenger SA	1	64.1%	45.4%	38.5%	33.0%	20.1%	-6.8%
Private Passenger SA & HO	36	67.4%	54.8%	43.8%	35.4%	15.9%	-13.4%
Workers' Compensation	4	70.2%	56.6%	50.5%	47.5%	40.6%	32.7%

Guy Carpenter & Company LLC conducted an analysis of 92 NAMIC mutual member companies to determine the potential BCAR impact of the inclusion of confidence levels of 99.8 and 99.9 VaR (see Exhibit 1). The companies participating represented multiple regions, sizes, product lines and profiles. The data analysis by Guy Carpenter illustrates the concern about using the higher return periods to achieve these confidence levels. The results at the higher confidence levels are quite volatile and show little relationship to current company ratings. The average BCAR score for all NAMIC companies in this sample fail at the 1:1000 return period and many "A-" and "B++" rated companies fail at the 1:500 and 1:1000 return periods. The lack of reliable historical data to evaluate the tail risk, results in uncertainty and potentially inaccurate information. Any reliance on this type of information to assess balance sheet strength is misplaced.

A.M. Best indicates that it intends to collect the information at the higher confidence levels for use in the ERM analysis, but will not apply the information to Balance Sheet Strength Assessment. Based on the Guy Carpenter & Company LLC Analysis, NAMIC believes that any publication of this information would be potentially harmful. This harm may disproportionately impact small companies as modeling at high confidence levels for small companies remains imprecise and abstract. However, any company could suffer unintended consequences – including competitive, regulatory or counterparty consequences – from publication of specific confidence level information. In fact, for a company undergoing a ratings review, public disclosure of modeling results would have the potential to increase enterprise risk. Certainly A.M. Best does not intend for its process to create increased risk to the rated entities. For these reasons we strongly recommend that any information collected at any confidence intervals should remain confidential and not part of public reporting.

A.M. Best also seeks feedback on the use of these higher return periods and confidence levels in the modeling used in ERM analysis. NAMIC agrees that this modeling is more often a tool of the ERM analysis and may be more appropriate in that context for the BCRM. However, there are many ways to develop a successful ERM program. More important factors are: 1) whether the program is designed for the company's unique risks so that it will be incorporated into decision-making; and 2) whether management's view of enterprise risks is thoughtful and measured. The use of a particular model with particular confidence levels is not indicative of success for every company. So while it makes sense to consider stochastic analysis and high confidence levels in the ERM context, these features should not be the only factors that lead to upward notching for ERM.

Finally, in the May 5th update, A.M. Best questions the use of stochastic simulations on an industry level. NAMIC agrees that the use of stochastic simulations in the rating of companies applied on a case-by-case basis is more reasonable. Stochastic simulations may not be appropriate for all companies rated and may not be comparatively relevant for every line of insurance or every enterprise risk. We support a review of the field testing that has been initiated by A.M. Best with rated companies to determine the outcomes of stochastic simulations before adopting the changes to the methodology at an industry level.

Recommendations: NAMIC appreciates the attempts to make the rating process more precise providing a better measurement of the strength of companies rated.

- NAMIC agrees with the A.M. Best suggestion in the May 5, 2016 update that confidence intervals of 99.8% and 99.9% VaR be eliminated from the balance sheet strength

assessment. We also suggest that any information collected at these confidence intervals remain confidential.

- NAMIC agrees that stochastic modeling is more often a tool of the ERM analysis and may be more appropriate in that context for the BCRM. However, there are many ways to develop a successful ERM program and the analysis should consider incorporation of ERM into decision-making, management's view of any modeling, and the results of the ERM program instead of over-relying on modeling. NAMIC supports the use of stochastic modeling on a company by company basis but recommends that such modeling not be strictly determinative of the ERM scoring.

C. Catastrophe Risk Emphasis

The consideration of catastrophe risk as a direct capital requirement instead of one considered within the covariance calculation is inconsistent with the NAIC RBC proposed approach to catastrophe risk. While we are aware that there are significant differences between the goals of rating capital and regulatory capital requirements, for the most part, the structure has remained similar. Variations between the two capital models have usually been illustrated in calibration levels, factors and the BCRM, not in significant differences in formula structure.

Catastrophe risk is certainly an important component of risk and one worthy of a separate risk category, but it should be captured in the context of premiums and reserves. It should be included in the covariance calculation at each confidence level, not excluded.

- The calculation of cat risk at the rating unit level makes the direct impact on required capital all the more significant. Once all of the modeled cat risks of all rating units are consolidated at the holding company level the impact could be very significant.
- Actuarial best practice is to include within the covariance calculation items that are not correlated to each other and put outside the covariance calculation the risk categories that are related to each other. Cat risk is not necessarily related to premium risk, reserve risk, investment risk etc.
- The proposal states that the treatment of cat risks as a direct addition to required capital is taken since such risks can occur concurrently with non-cat risks. However, under this logic by adding all modeled cat losses for the entire enterprise together, the proposal also anticipates that every cat risk insured within a holding company will or could occur in the same year. Since this is very unlikely to happen, inclusion in the covariance calculation is justified.
- Ratings are reviewed annually, and adjustments can be made if there are problems with the occurrence of a catastrophe. It is unnecessary to add this level of uncertainty to the rating process when it can be corrected the following year.
- Finally, we ask that you clarify that the catastrophe risk analysis in the BCRM methodology is made on a tax-adjusted basis as tax implications can have a significant impact on catastrophe risk.

Recommendation: The importance of catastrophe risk in the BCAR criteria is overestimated by adding a rating unit's modeled cat losses directly to the required capital at each confidence level and excluding them from the covariance calculation. NAMIC urges the adjustment of catastrophe risk by the covariance calculation.

Conclusion

Overall the changes in the A.M. Best methodology represent improvements to the process of developing credit rating for property-casualty companies. Many of our members indicate that the added precision of the formula will reveal the significant strength of the mutual business model in general and mutual insurance companies in particular. There remain some areas of possible improvement that we have discussed in this letter:

- NAMIC believes the negative impact of the revised methodology for mutual, single state or niche carriers was not intended to indicate a credit rating issue with mutual, single state and niche companies, but those may be the unintended consequences. We made several suggestions to improve the potential rating for these companies.
- The perceived authority granted to the analysts to revise a rating unit or holding company score related to notching either the Balance Sheet Strength or several levels of the BCRM seems to create significant latitude for varying ratings for similarly situated companies. NAMIC recommends more specific notching guidelines be disclosed.
- The analysis of investment risk the same for life and non-life companies was questioned by NAMIC. Differing business models generating different investment portfolio structures warrant a new look at this issue.
- The May 5 Update proposed by A.M. Best to eliminate higher confidence levels from the BCAR analysis and to use stochastic simulations as indicated on a company-by-company basis is supported by NAMIC. We also included our recommendations on confidentiality of all modeling information and on ERM evaluations on an outcomes basis.
- Finally, NAMIC raised concerns about the BCAR catastrophe risk placement as a direct addition to required capital. We suggest adjusting cat risks by the covariance calculation.

Of course, NAMIC is willing to discuss all issues raised with A.M. Best and remains optimistic that reasonable resolutions can be reached. It is in the best interests of A.M Best and the entire industry that the rating analysis is done fairly and comparatively accurately. Identifying reasonable revisions that will improve the accuracy of the rating is our common goal. We hope these suggestions have proven valuable and productive in A.M. Best's efforts to improve its rating system. Thank you for the opportunity to provide comment and for the transparent nature of the review process.

Sincerely,

Michelle M. Rogers
Director of Financial and Regulatory Policy
National Association of Mutual Insurance Companies