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Clal Insurance Company Ltd.

Monitoring Report | October 2017

This credit rating report is a translation of a report that was written in Hebrew for a debt issued in Israel.

The binding version is the one in the original language.

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Clal Insurance Company Ltd.

Insurer financial strength (IFS) rating	**Aa1.il**	**Rating outlook: Stable**
Subordinated Tier II capital	**Aa2.il(hyb)**	**Rating outlook: Stable**
Hybrid Tier II capital	**Aa3.il(hyb)**	**Rating outlook: Stable**

Midroog affirms Aa1.il Insurer Financial Strength (IFS) rating for Clal Insurance Company Ltd. ("the Company") and affirms Aa2.il(hyb) rating for subordinated notes (subordinated Tier II capital) issued by the Company and through Clalbit Finance Ltd. ("Clalbit Finance") and affirms Aa3.il(hyb) rating for subordinated notes (Hybrid Tier II capital) issued through Clalbit Finance. Rating outlook – Stable.

Outstanding debentures rated by Midroog:

Series	Securities ID	Rating	Rating outlook	Type of regulatory approved capital	Final maturity
Private 1	–	Aa2.il(hyb)	Stable	Subordinated Tier II	January 31, 2018
A	1097138	Aa2.il(hyb)	Stable	Subordinated Tier II	June 1, 2021
B	1114347	Aa2.il(hyb)	Stable	Subordinated Tier II	June 9, 2018
C	1120120	Aa3.il(hyb)	Stable	Hybrid Tier II	August 1, 2024
F	1120138	Aa3.il(hyb)	Stable	Hybrid Tier II	August 1, 2020
I	1136050	Aa3.il(hyb)	Stable	Hybrid Tier II	July 31, 2028
J	1136068	Aa3.il(hyb)	Stable	Hybrid Tier II	July 31, 2027

Summary of Rating Rationale

The Company's rating reflects the Company's good business profile, due to the significant size and reasonable diversification of business lines, which support its revenue generating ability. The rating also reflects an appropriate risk profile, considering relatively low product risk and appropriate risk management policy, good financial strength stemming from good capital adequacy - based on Midroog's capital model and appropriate regulatory ratios that support business flexibility. With the liquidity profile prominently favorable and positively affected by the long duration of liabilities. On the other hand, the Company has reasonable assets quality and financial flexibility Which does not stand out favorably for the rating, along with weak profitability throughout the cycle, which is limited by a rigid expense structure and a still significant proportion of collectives that impact the risk profile.

According to Midroog's capital model, the Company has appropriate risk adjusted capital surplus for the current rating (the first stress scenario out of five by severity) with a capital surplus of 102% based on June 30, 2017 data. The main risks to which the Company is exposed, as perceived in the model, derive from insurance risks, in particular, life expectancy risks in policies with guaranteed annuity and from market risks in the nostro portfolio (guaranteed-return life insurance, P&C and Equity). Moreover, in accordance with the Solvency 2 directives, the SCR ratio as of December 31, 2016 was 111% and 179% (without / with accounting for the transition period, respectively), which support the Company's risk profile and business flexibility. However, Midroog expects that the Company would act to maintain a safety margin from the regulatory threshold, in view of the higher volatility of the capital ratio, compared to the current regime.

In the forecast for 2017-2018, we estimate that the Company would maintain its business positioning, while increasing earned premiums by a cumulative 7%-10% compared to 2016, primarily due to the change in the rate of pension provisions, with this un-changed annual organic growth rate expected to be within a range similar to that of GDP growth.

In our opinion, the main profit generators will be the life insurance and healthcare insurance segments, while the mandatory motor liability insurance segment, which recorded high profitability in recent years, is expected to continue to sustain losses in the short term, pending full adjustment of the rates in respect of the increase in claim costs. The business environment would remain challenging, with moderate growth but stable unemployment, which would result in further increase in real wages. On the other hand, we see no pressure for a significant rise in the interest curve over the short-term, with the potential for returns in the capital market remaining moderate and volatile in our assessment. In the healthcare segment, we assume a certain moderation in growth, similar to the industry, and increased competition even in light of regulatory intervention; as for P&C insurance, we assume that existing market shares will be maintained even in view of limited underwriting profitability. We estimate that in the forecast range in 2017-2018, profitability is expected to remain low relative to the rating, with ROC and ROA ratios ranging between 2%-3% and 0.1%-0.2%, respectively.

The stable rating outlook reflects our expectation that the company would maintain key ratios in the range of our base scenario.

Clal Insurance Company Ltd. - Key financial data (NIS in millions)

	June 30, 2017	June 30, 2016	2016	2015	2014	2013
Total assets	**101,579**	**95,139**	**98,001**	**94,829**	**90,690**	**84,831**
Total equity attributable to equity holders of the Company	**4,714**	**3,856**	**4,513**	**4,402**	**4,147**	**3,766**
Total comprehensive income (loss) attributable to equity holders of the Company	**200**	**(546)**	**112**	**269**	**381**	**642**
Total Earned premiums, gross	**4,890**	**4,439**	**9,111**	**9,055**	**9,031**	**9,294**
Of which: life insurance and long-term savings	*2,860*	*2,408*	*4,999*	*4,861*	*4,722*	*4,875*
Of which: healthcare insurance	*912*	*856*	*1,799*	*1,674*	*1,616*	*1,613*
Of which: P&C insurance	*1,119*	*1,176*	*2,315*	*2,522*	*2,696*	*2,818*
Total premiums earned in residual	**4,330**	**3,918**	**8,068**	**7,998**	**7,897**	**8,138**
Total investment gain	**2,718**	**340**	**2,611**	**3,001**	**4,036**	**6,631**

Midroog's adjusted ratios

Intangible assets and long-term deferred acquisition costs to shareholder equity	56%	69%	60%	60%	61%	64%
Shareholder equity to total assets (excluding return-based)	12%	10%	11%	11%	11%	10%
Return on capital (ROC) [1]	5.1%	-15%	1.4%	3.7%	5.8%	10.8%
Return on assets (ROA) [2]	0.4%	-1.1%	0.1%	0.3%	0.4%	0.8%
Adjusted debt to adjusted debt and shareholder equity [3]	41%	45%	43%	43%	41%	41%
Earnings before interest and tax (EBIT) to interest expenses	6.3x	-9.7x	1.4x	6.6x	4.4x	9.0x

[1] Comprehensive income to average financial liabilities and equity attributable to shareholders during period, annualized

[2] Comprehensive income to average assets in the period, annualized

[3] Adjusted debt including financial liabilities and liabilities in respect of employee benefits, net

Detailed Rating Considerations

Good business profile in view of significant size supporting the revenue generation ability

The Company is one of Israel's three largest insurance companies in terms of gross premiums as of June 30, 2017 with significant assets under management amounting to NIS 180 billion[1]. The Company has a strong brand, which is reflected in significant market share over time in all operating segments, mainly in life insurance and healthcare insurance (19% and 17%, respectively, in the first half of 2017, in terms of gross earned premiums) of a wide, diversified customer base and appropriate control over distribution. In recent years, the Company has implemented a strategic plan to strengthen profitability in all segments, particularly in P&C insurance. As part of this plan, the Company has acted to improve the insurance portfolio by not renewing losing contracts, including collective business, in order to improve profitability of the underwriting core at the expense of size. As a result, the Company has maintained revenue stability in recent years, in contrast to the growth trend in the segment, with the primary impact on the P&C insurance segment, with 25% erosion in premiums between 2012-2016, a trend that was reversed in 2017 by growth in motor insurance segments operations.

The Company has reasonable business diversification, biased towards life assurance and long-term savings, while the other two segments, healthcare and P&C insurance, account for 19% and 23% of gross premiums in the past 12 months. These support profitability in view of the volatility in the life insurance segment, which is subject to significant external influences, including a decline in the interest rate curve, volatility in capital market returns and challenging regulation.

In the forecast for the years 2017-2018, we estimate the Company would maintain its business positioning, while increasing earned premiums by a cumulative 7%-10% compared to 2016, primarily derived from the life, and motor liability and property insurance segments. In the past year, the life insurance segment benefited from an

[1] According to company data

increase in the average contribution rate as percentage of wages, by 4% compared to the previous year[2] and from the increase in real wages[3] In view of the low unemployment rate. Whereas the first effect will moderate in 2018, we expect a continued supportive macro-economic environment, despite relatively moderate growth of around 3%, mainly due to expected stability in the unemployment rate, which should contribute to further slow increase in real wages. Excluding the effect of the increase in contribution rate, we estimate that the company revenues would grow at a similar rate to GDP growth in the next two years. In the healthcare insurance segment, we assume moderate premium growth, to be supported by a relatively low penetration rate. Conversely, competition is expected to increase also as a result of the introduction of the uniform insurance policy, so we expect continued price pressure in this segment with continued focus on individual insurance. In the P&C insurance segment, we estimate that the Company would maintain its existing market share with stable to moderate increase in premiums (contrary to the trend in recent years, as aforesaid), given further increased competition in the segment and limited price flexibility, due to underwriting margins (net combined ratio) which are not standout favorably relative to the industry average.

The risk profile is appropriate for the rating, supported by low product risk but still limited due to exposure to large customers

The Company is characterized by low product risk, which supports its underwriting ability and reduces underwriting risk, due to the higher level of certainty. In P&C and short-term healthcare insurance, about 67% of total gross premiums over time and in the past 12 months are with "short-tail" insurance contracts, which in our opinion are characterized by lower underwriting risk than "long-tail" contracts, due to higher uncertainty and lower business flexibility due to change in the business environment. Note that the Company did not renew the personal accident insurance policy for pupils, which should reduce the "long tail" risk compared to previous years. The Company hedges insurance risk in the P&C insurance segment through high-rated re-insurers, with proper diversification with relatively low exposure given a catastrophic event, at 1% of shareholder equity as of December 31, 2016.

In life assurance and long-term healthcare insurance, the "low risk" reserve rate, as defined by us, is appropriate for the rating at 47% as of 31 December 2016. This ratio reflects relatively low exposure to return-guaranteed provisions, excluding HETZ debentures, which expose the Company to significant external changes, including changes to the interest curve and capital market volatility, in addition to demographic risk. In the short and medium term, we do not anticipate material change in the reserve mix, given the expected operating mix.

We regard the company's focus on creating underwriting profitability and reducing exposure to collectives (about 45% of total premiums in P&C insurance in 2013, compared to 35% in 2016) as a positive, but it is still relatively

2 According to Amendment 16 to the Provident Fund Act, as from July 2016, the contribution rate by employee and employer to provident funds increased from 5.75% and 6% to 6% and 6.25%, respectively. As of January 2017, the employer contributions rate was raised to 6.5%. Accordingly, the average contribution rate in 2016 was 11.75%, compared to 12.5% as from 2017. The contribution rate for severance pay remained unchanged at 6%.

3 According to Bank of Israel data, the real wage index rose in the first six months of 2017 by about 4%

high. This exposure is a negative for the rating, for earnings visibility and for the capacity to build-up the capital cushion, because it may increase underwriting, credit and sector risk throughout the cycle and limit risk-adjusted pricing, given economies of scale for customers.

The Company's risk management policy and controls are appropriate for the rating and are also supported by regulatory requirements. Full implementation of the Solvency II Directive should further improve the Company's risk management processes, as well as the industry's, and should support improvement of the risk profile over time and measurement of economic capital, although it would be more volatile. The Company's relatively good preparedness for capital requirements under the new capital regime further supports the Company's good risk management practice and its business flexibility.

Note the uncertainty regarding the date and outline for sale of shares of the parent company, Clal Insurance Business Holdings Ltd. (hereinafter: "the parent company") and the quality of the buyer, should such a transaction be realized. Currently, the outline of the sale of shares on the market by the Trustee continues. A leveraged sale outline may change the Company's risk profile, as the Company has not distributed dividends in recent years, depending on the repayment burden of such buyer. Midroog will continue to monitor developments in this regard and their impact on the Company's risk profile.

Asset quality is reasonable relative to the rating, due to the relatively high ratio of "assets at risk" and intangible assets

The Company's nostro investment profile indicates a risk appetite that is reasonable for the rating, similar to the comparison group, with a ratio of adjusted "assets at risk"[4] to regulatory approved capital at 45% as of June 30, 2017. However, this component only constitutes 20% of the total investment portfolio (excluding return-dependent investments). The Company has a diversified investment portfolio and no significant exposure to any specific investment component other than government debentures. Thus, the investment mix in the nostro portfolio as of June 2017 primarily consists of government debentures, at 52%, private loans (primarily mortgages) at 13%, corporate debentures at 9% and cash at 5%, With other investments diversified and less material.

Note that the Company's investment portfolio mix (only P&C insurance and equity, without return-guaranteed life insurance) as of June 30, 2016, includes a high rate of private loans at 27%, compared with 13% for the segment, primarily due to the Company's mortgage operations and supports returns in a low interest environment. In our opinion, no material change is expected in the portfolio mix, with further investment in non-tradable assets, in view of the current interest environment and the low return potential on the capital market.

The ratio of intangible assets to equity was 55% as of 30 June 2017, reflecting a high rate for the rating of deferred acquisition costs in life insurance and goodwill relative to shareholder equity as a derivative of the operating mix. This ratio has improved in recent years (65% in 2013) due to an increase in the capital cushion along with write-

4 High risk assets generally include all financial investment assets other than cash, Government debentures and investment-grade corporate debentures, with the weighting of the latter based on partial reliance reflecting risk of potential impairment over the credit cycle due to credit, market or liquidity risk.

off of goodwill in respect of provident fund operations. We expect improvement in this ratio in the short and medium term, given our estimate of moderate growth and stability in the operating mix, along with some improvement in the capital cushion.

The capital cushion is appropriate for the rating and absorbs losses well; The potential for improvement is limited in the short term

According to Midroog's capital model, the Company has appropriate risk adjusted capital surplus for the current rating (the first stress scenario out of five by severity) with a capital surplus of 102% based on June 30, 2017 data. The main risks to which the Company is exposed, as perceived in the model, derive from insurance risks and in particular life expectancy risks in policies with guaranteed annuity and from market risks in the nostro portfolio (guaranteed-return life insurance, P&C and equity). Against these risks, the Company has an economic capital cushion with adjusted shareholder equity as of June 30, 2017 amounting to NIS 4.6 billion and significant adjusted VIF amounting to NIS 6.0 billion.

As a complementary test, not based on risk weighting for insurer leverage, we consider the ratio of equity to adjusted total assets (excluding assets for return-dependent contracts) excluding 10% of assets at risk, which reflect the expected erosion in asset value under more stringent scenarios. This ratio was around 11% on June 30, 2017, which is appropriate for the rating and we believe should remain at a similar level over the short to medium term.

In June 2017, updated directives were published for implementation of an economic solvency regime for insurers, based on Solvency II ("**the new directives**"), whereby insurers would maintain an economic solvency regime in accordance with the directives and concurrently comply with existing capital regulations pending approval by the Commissioner of an audit of implementation of the new directives on the financial statements. Therefore, pending receipt of the Commissioner's approval, the Company is subject to both the capital regulations and the new directives concurrently. As of June 30, 2017, the Company has a capital ratio of 167% in accordance with the capital regulations, and a solvency ratio according to the new directives (SCR) as of December 31, 2016 of 111% and 179% (without / with accounting for the transition period, respectively), which are reasonable for the industry. Note that the Company has a significant capital surplus of NIS 4 billion, according to milestones over the transition period[5], which supports its risk profile and business flexibility. However, Midroog expects the Company to act to maintain an appropriate safety margin from the regulatory threshold, given the higher volatility relative to the current regime.

In September 2017, a revised draft letter was published regarding dividend distribution by insurers ("**the letter**"). According to the letter, insurers may distribute dividends if, after such distribution, its solvency ratio (SCR) would be at least 100%, calculated excluding transitional provisions and excluding adjustment of the share scenario and subject to the target solvency ratio specified by the Board of Directors. In view of the new directives in the letter,

5 The capital required for solvency of an insurer in the period from June 30, 2017 to December 31, 2024 would gradually increase by 5% annually, from 60% of SCR to 100% of SCR.

the Company's solvency ratio is expected, subject to capital targets to be specified, to allow the Company to distribute dividends over the short to medium term. However, we did not take into account that the Company would indeed make such distribution in the forecast period for 2017-2018. We believe the build-up of the capital cushion over the short and medium term to be relatively limited given the challenging business environment, which in our opinion results in a relatively low earning potential, as set forth below.

Weak profitability relative to the rating; Expected further pressure on profitability due to the challenging business environment

The Company is characterized by relatively weak profitability throughout the cycle, both relative to the rating and to the peer group, which was eroded in recent years as a result of the challenging business environment. Profitability is limited by a relatively rigid expense structure that results in low operating efficiency and exposure to large customers, despite the ongoing reduction due to the strategic focus that still weighs down on underwriting profitability, which is not significant enough to absorb fluctuations in the capital market. The industry exposure and the Company exposure to external factors, particularly to the capital market, and the lack of significant underwriting profitability, result in high volatility in profitability, as reflected in the Company's ROC and ROA ratios ranging between 1.4%-10.8% and 0.1%-0.8%, respectively in 2013-2016. The decrease in profitability is due, inter alia, to the need to supplement reserves in light of the continuing decline in the interest curve and impact to the revenue generating potential, particularly the variable management fees and investment gains, as well as impact of the Vinograd Commission on the capitalization interest rate for Social Security claims, which have affected and should continue to affect the underwriting profitability in mandatory motor liability insurance and liability insurance. In the last six months, the Company posted relatively good profitability, due to the increase in the interest rate curve and high returns achieved on the capital market, which reflect the Company's sensitivity to external fluctuations. However, since June the risk-free real interest curve has declined considerably, a fact that is expected to lead to higher insurance liabilities at the Company. Conversely, financial assets appreciated so as to reduce the effect of increased liabilities.

In our forecast for 2017-2018, we expect a continuation of the challenging business environment, similar to the previous two years, which would weigh on the insurance industry, especially the potential for generating profits and the ability to build up the capital cushion from current earnings. The business environment should continue to be affected by relatively moderate GDP growth (3.1% to 3.3% in 2017-2018), the low interest, low inflation environment, some stability in the steepness of the curve along with volatile returns on the capital market and exposure to the regulatory burden, which promotes competition and generates additional costs in certain segments. Conversely, we believe that penetration rates should continue to grow, especially in the healthcare segment, which has grown significantly in recent years and is expected to continue to grow, albeit at a more moderate pace. Furthermore, recent regulatory changes in the industry, including the creation of a uniform insurance policy structure, are expected to increase price competition and to pressure profitability in the industry. In the P&C insurance segment, competition should remain relatively high and underwriting margins should remain moderate and even negative, due to regulatory effects and despite a certain price increase, primarily in the motor insurance segment. We expect moderate profitability in the life assurance and long-term savings segments, which would continue to be significantly affected by external factors, primarily by volatility in capital market returns. Within the forecast range, we estimate some improvement in underwriting results in the healthcare and P&C segments, but the operating efficiency should remain limited. The profit generators would be the life and healthcare insurance segments, with mandatory motor liability insurance, a segment which has shown high profitability in recent years, expected to continue to suffer losses over the short term, pending full rate adjustment with respect to higher claim cost. Profitability margins are expected to remain low relative to the rating, with ROC and ROA ratios ranging between 2%-3% and 0.1%-0.2%, respectively, in 2017-2018.

Favorable liquidity profile supported by a long duration of liabilities, low financial flexibility relative to the rating is negatively impacted by high financial leverage, but is supported by a sufficient headroom from regulatory capital adequacy

The Company's liquidity profile is favorable for the rating and for the peer group, as reflected by a current ratio of 3.5 times between weighted liquid assets to short-term insurance and financial liabilities. Given the Company's business mix, which is biased towards life insurance, most of the liabilities are naturally expected to be repaid over the long term, and no significant principal repayment is expected for financial liabilities over the short term.

Company liabilities have a relatively long duration, which strongly supports its liquidity profile and rating. In our opinion, insurers characterized by a long duration of liabilities and no put options for policyholders to call for cash out, are less exposed to liquidity risk and are better capable of responding to them over a longer period of time, which supports their survivability and rating. Moreover, the volatility that may result from mark to market of assets (MTM) sometimes does not reflect the economic value of insurers with a long duration of liabilities, given their ability to hold the relevant assets to maturity, therefore the economic capital of these insurers may be less exposed to short-term market volatility in our opinion.

The company's financial flexibility is low for the rating and is characterized by a relatively high balance sheet leverage ratio of around 40% as of June 30, 2017, similar to the peer group, which we believe should not materially change over the short to medium term. The Company also has interest coverage ratios (EBIT to cash flow interest expenses) that are relatively slow, expected to range between 2-3 in 2017-2018. Conversely, the Company is compliant with solvency ratios in accordance with the new directives (SCR) with a significant headroom during the implementation period and excluding transitional provisions, which supports the Company's financial flexibility.

Rating outlook

Factors that could lead to a rating upgrade:

- Significant improvement in business diversification
- Significant improvement and stability over time in earnings cushion

Factors that could lead to a rating downgrade:

- Continued erosion of capital surplus according to Midroog's capital model
- Continued deterioration in underwriting results in core segments and/or significant, prolonged erosion in overall earnings
- Change in ownership structure that would affect the Company's risk profile, including aggressive dividend distribution

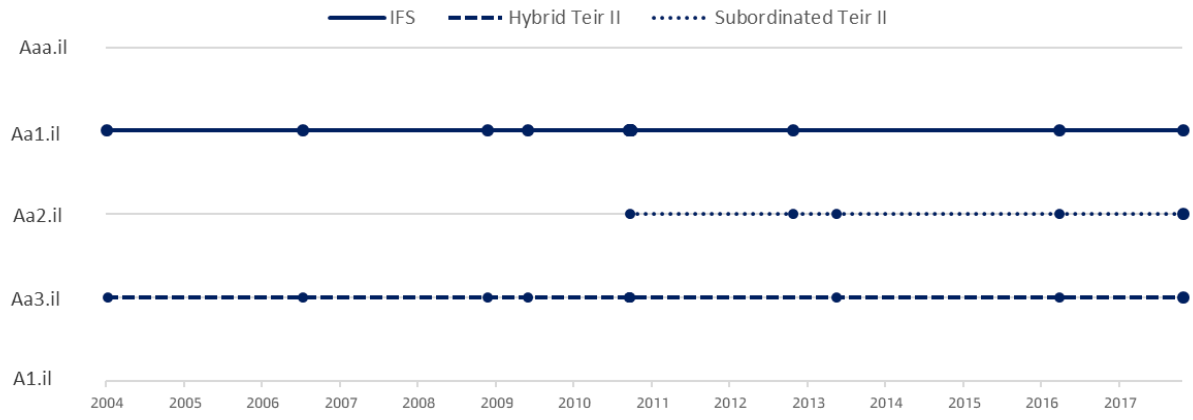
Company’s Profile

The Company was incorporated and registered in Israel on September 10, 1962. The Company is a wholly-owned subsidiary (99.98%) of Clal Insurance Business Holdings Ltd. (hereinafter: "**Clal Holdings**"). Clal Holdings shares are listed for trading on the stock exchange.

The main shareholders of Clal Holdings are IDB Development Corporation Ltd. ("**IDB Development**"), which holds, by itself and through a Trustee, 44.9% of Clal Holdings shares, and Bank Hapoalim Ltd., which holds 9.5% of Clal Holdings shares. Pursuant to the requirements of the Insurance Commissioner, on August 21, 2013, IDB Development transferred 51% of Clal Holdings issued share capital and voting rights held by IDB Development ("**the means of control**") to Mr. Moshe Terry, who serves as Trustee for IDB Development in order to exercise the powers conferred there upon by virtue of the means of control, in conformity with provisions of the Deed of Trust. The CEO of the Company is Mr. Izzy Cohen.

The Company primarily does business in insurance, pension and provident funds and is one of the largest insurance companies in Israel. Company operations and its subsidiaries are mainly focused on three operating segments: Long-term savings, P&C insurance and healthcare insurance. Insurance operations are generally conducted in Israel. Insurance operations are conducted by the Company, with the exception of credit insurance operations, conducted by Clal Credit Insurance.

Rating History



Related reports

Clal Insurance Company Ltd. – Rating action report – December 2016
Clal Insurance Company Ltd. – Monitoring report – October 2016
Methodology for rating life, healthcare and P&C insurance companies - July 2016
Midroog's rating scales and definitions

These reports are available on the Midroog website at www.midroog.co.il

General information

Rating report date:	October 30, 2017
Most recent rating update date:	December 19, 2016
Initial rating issue date:	November 2, 2004
Rating initiated by:	Clal Insurance Company Ltd.
Rating paid for by:	Clal Insurance Company Ltd.

Information from the issuer

In its ratings, Midroog relies, inter alia, on information received from competent organs of the issuer.

Long-Term Rating Scale

Aaa.il	Issuers or issues rated Aaa.il are those that, in Midroog judgment, have highest creditworthiness relative to other local issuers.
Aa.il	Issuers or issues rated Aa.il are those that, in Midroog judgment, have very strong creditworthiness relative to other local issuers.
A.il	Issuers or issues rated A.il are those that, in Midroog judgment, have relatively high creditworthiness relative to other local issuers.
Baa.il	Issuers or issues rated Baa.il are those that, in Midroog judgment, have relatively moderate credit risk relative to other local issuers, and could involve certain speculative characteristics.
Ba.il	Issuers or issues rated Ba.il are those that, in Midroog judgment, have relatively weak creditworthiness relative to other local issuers, and involve speculative characteristics.
B.il	Issuers or issues rated B.il are those that, in Midroog judgment, have relatively very weak creditworthiness relative to other local issuers, and involve significant speculative characteristics.
Caa.il	Issuers or issues rated Caa.il are those that, in Midroog judgment, have extremely weak creditworthiness relative to other local issuers, and involve very significant speculative characteristics.
Ca.il	Issuers or issues rated Ca.il are those that, in Midroog judgment, have extremely weak creditworthiness and very near default, with some prospect of recovery of principal and interest.
C.il	Issuers or issues rated C are those that, in Midroog judgment, have the weakest creditworthiness and are usually in a situation of default, with little prospect of recovery of principal and interest.

Note: Midroog appends numeric modifiers 1, 2, and 3 to each rating category from Aa.il to Caa.il. The modifier '1' indicates that the obligation ranks in the higher end of its rating category, which is denoted by letters. The modifier '2' indicates that it ranks in the middle of its rating category and the modifier '3' indicates that the obligation ranks in the lower end of that category, denoted by letters.

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