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Rating Funding Agreement-Backed Securities Programs

This criteria procedure describes A.M. Best's approach to rating the securities and related programs where the notes to be rated are secured by funding agreement contracts issued by U.S. life insurers.

Summary

Historically, a number of large U.S. life insurance companies have funded a significant portion of their institutional spread business by issuing funding agreement-backed securities (FABS) through private placement securitization vehicles such as European Medium Term-Note (EMTN) and Global Medium Term-Note (GMTN) programs, as well as Securities and Exchange Commission (SEC)-registered programs. As such, A.M. Best will assign ratings to each FABS issuance under these programs.

A.M. Best views FABS programs as a reasonable activity for highly rated companies with diverse lines of business, considerable expertise in asset/liability and investment management, and strong financial flexibility.

Through the typical FABS program structure, investors are exposed to the inherent credit, liquidity and business risks of the sponsoring insurance company. Therefore, A.M. Best will assign an Issuer Credit Rating (ICR) to the program and Issue Credit Ratings (IR) to the various tranches. The ICR is A.M. Best's opinion as to the ability of the issuing insurance company to meet its financial obligations. Notes issued under a standard FABS program will receive issue credit ratings that are the same as the ICR of the sponsoring insurance company (and also of the program), reflecting that: (1) the underlying funding agreements (FAs) are obligations of the insurer's general account and (2) the FAs are typically *pari passu* with other insurance contracts issued by the company based on the regulations of the insurer's state of domicile.

A.M. Best's analysis may entail reviewing the insurance laws of the state of domicile for each issuer, as well as reviewing independent legal opinions in states where the regulations are unclear. In addition, A.M. Best may review the insurers' asset/liability management processes to ensure that a close match is maintained between the funding agreements' assets and liabilities.

The rating analysis will be similar to considering the risks inherent in other spread-based products such as guaranteed investment contracts (GICs), which generally are issued to pension plans and municipalities. Since the net proceeds from FABS issuances are used in matched funding operations, A.M. Best views GICs and FAs as operating leverage, not as financial leverage.

Finally, A.M. Best's analysis may incorporate the organization's overall ability to support the institutional spread-lending business in establishing limits for these products on a company-by-company basis. Companies that issue substantial volumes of "stable value" products, or where the majority of general account liabilities comprise institutional investment products, may experience downward pressure on their ratings.

Overview

For the insurers that have participated in institutional investment markets, FABS programs have been an attractive alternative to non-tradable GICs and FAs, which appeal only to a limited buyer

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base. Because the notes are tradable securities, FABS programs attract a wider base of buyers than the illiquid GIC/FA products, allowing companies to diversify funding sources and reduce their overall cost of funds. Also, the notes offer investors access to high-quality issuers at a level higher up in the capital structure than senior bondholders, with attractive relative spreads.

In broad terms, FAs are nonqualified annuities or annuity-like instruments that are designed specifically to generate regular cash flows to service the debt on short-term or medium-term notes issued through a securitization vehicle – a trust and/or special-purpose vehicle (SPV). The structure transfers the credit quality of a policyholder claim at the insurance company to the notes of the SPV. FAs are more appropriate than GICs for use in securing note issuance programs because of the lack of life, health or employment contingencies in the FA contracts. FAs are governed by the laws of the underwriting insurer's home state, whereas the notes, like most U.S. corporate securities, ordinarily are governed by New York law.

Funding Agreement-Backed Securities Programs

The owner and holder of the FA is typically an SPV located outside of the United States. Since the offshore SPV is not an insurance company, the regulatory process is streamlined. Insurers that issue the notes through these structures are not subject to European regulatory oversight as they are not directly selling insurance policies. In addition, the notes are not subject to U.S. tax laws.

The programs initially were set up to issue amounts in various European currencies. To effectively eliminate mismatch, the terms of the FAs match the terms of notes to be issued by the SPV. Additionally, the insurers and SPVs may enter cross-currency and interest-rate swaps with swap counterparties to reduce the risk of currency and payment mismatches. One approach that companies have utilized in FABS structures is where the FA is written in the foreign currency and the insurer makes the foreign currency payments by means of a swap contract. An alternative method has the FA written in U.S. dollars, and the SPV would swap the FA payments into the necessary foreign currency before passing them on to the noteholders.

Direct purchase of the EMTN notes is restricted to non-U.S. investors; the notes are listed in the bond section of the Luxembourg Stock Exchange. Maturities generally range from three to 30 years. Once the notes are “seasoned” (i.e., out of the restricted period, approximately 40 days) they can be actively traded without limitations. Distributors eschewed selling FABS in the United States until the insurance regulators could be satisfied that the notes were investment products rather than insurance contracts.

The insurer establishes the maximum aggregate principal amount for its FABS program, but the notes can be issued in unlimited series or tranches. The notes, which are nonstandard and designed to meet the diversification needs of investors, can be fixed or floating rate or zero-coupon. A.M. Best may rate both the program and particular series within each program.

Program Structure

Within FABS program structures, the SPV or trust is a bankruptcy-remote entity. The SPV generally has no prior business history, and its sole purpose is to issue notes secured by FAs of the underlying insurer. The FA is a direct senior obligation of the insurance company. Held by a trustee, the FA is the SPV's primary asset and the source of funds to pay the noteholders in the program. The terms of the FAs (rate, maturity and principal) generally match the terms of the notes or bonds. If the issuer fails to satisfy the stated contract terms, the noteholders have recourse to the FA issued to the trust or SPV, but the notes are non-recourse to the insurer.

The insurer and/or the SPV also may engage in swap agreements to match the cash flows from the FA with the obligations of the SPV to make payments on the notes. Typically, swaps are used

when the notes are denominated in a different currency than the FA. Where swaps or other derivatives are used, this creates an additional source of assets, as well as liabilities, for the SPV.

The SPV is needed to convert a non-tradable insurance product (the FA) into liquid investment products (the notes). The notes are a form of securitized instrument in that they pass along the proceeds of the FA in a structured manner, and derivative, as they track the behavior of another instrument, the bond or note. Hence, the FAs and the notes have analogous payment structures.

In offshore programs, any funds remaining at the SPV level after all notes mature are funneled to a charitable organization. In certain domestic programs, leftover funds would be returned to a beneficial owner other than the insurer. In general, when the notes mature, the SPV terminates and returns any excess funds to the insurer.

The FA is assigned to the trustee for the benefit of the notes' investors. Security interest perfection is achieved by the trustee who takes possession of the funding agreements. Additionally, the trustee may file financing statements in the state where the trust was incorporated and/or the insurer's state of domicile, naming the SPV as the debtor and the trustee as the secured party for the benefit of the note investors.

Key Rating Factors

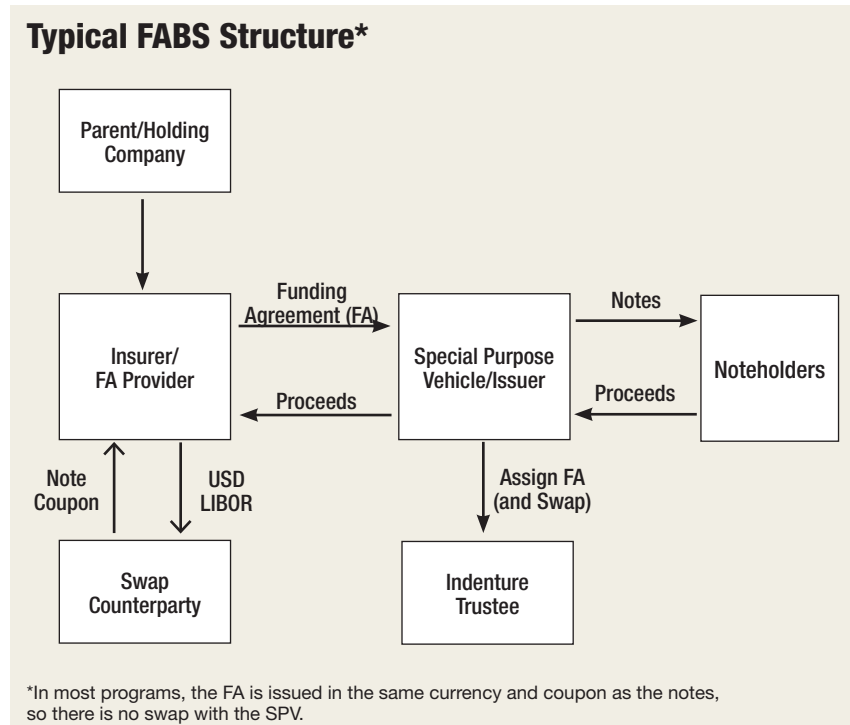
1. Issuer Credit Rating

The ICR of the issuing insurance company is A.M. Best's opinion of the insurer's ability to meet its ongoing financial obligations. Notes issued under a standard FABS program will receive the same ICR as the sponsoring insurance company, reflecting that: (1) the underlying FAs are obligations of the insurer's general account and (2) the FAs are *pari passu* with other insurance contracts issued by the company based on the regulations of the insurer's state of domicile.

The rating assigned to the program is generally assigned to each tranche. An exception would be if credit risk is embedded in any of the tranches in addition to the insurer's credit risk in these tranches (e.g. credit-linked or index features), which may cause the rating of the notes to be notched lower. A.M. Best believes these exceptions are uncommon. Programs/notes that are credit enhanced may be assigned a higher rating than the insurer's ICR. These cases also are atypical.

2. State Regulatory Opinions on Priority of FAs

A crucial issue is whether the FAs are *pari passu* with policyholder claims; that is, whether the insurer's state of domicile treats the FA as an insurance liability of the



general account. Many states have specific language in their regulations stating that FAs are considered policyholder liabilities and therefore receive the highest priority of claims. In states where FAs are junior to general account policyholder obligations, the rating of the program/notes, all other factors being equal, would rank below that of the insurance operating company.

A.M. Best may review the insurance laws of the state of domicile for each FA issuer as well as solicit independent legal opinions, especially for states where the regulations are unclear.

3. FABS Structure

An important aspect of relating the insurer's ICR to the rating of the program/notes is to understand the relationship between the FA and the note program. The legal and economic structures may be analyzed, including how well the payment requirements of the FA and notes are coordinated. Some note programs tie the note payments to risks other than the insurer's credit, and these risks must be evaluated to determine whether they create downward pressure on the rating. Furthermore, since the net proceeds from funding agreements are used in matched funding operations, A.M. Best views this as operating leverage.

The analysis of the FABS program structure is similar to that of a leveraged lease or other structured-financing arrangement. A major consideration in the analysis is the extent to which state insurance laws govern. The inquiry also has legal components relating to the enforceability of the notes' security interest provisions under the commercial laws of the insurer's and the SPV's domicile. Finally, the analysis should consider: (1) how direct is the investors' recourse to the FA; (2) whether the flow of FA payments to investors is impeded; and (3) how strictly the noteholders can enforce their security interest in the FA.

4. ALM and Liquidity Factors

FA providers must employ sophisticated asset/liability management techniques and possess expertise in fixed-income and portfolio management, as well as proficiency in the structuring and management of the FABS program – similar to the skill set necessary for managing a profitable GIC issue.

Although the FA's assets generally are only notionally segregated in the insurer's general account, a close match between the funding agreement's assets and liabilities should be maintained. However, this match could be disrupted, for example, when interest rates decline and the durations of certain assets shorten.

To compensate, an insurer may fund a floating-rate FA with fixed-rate assets and then "swap" the resulting fixed payments for floating-rate payments. Although this mitigates interest risk, the insurer still is exposed to credit risk.

In general, accepting more asset risk can enhance spreads for the insurer, though this may be at the expense of increased asset/liability mismatches and investment losses. The risks are similar to those of other spread-based products, such as pension GICs. A.M. Best views GICs and FAs as commodity products with relatively low margins as the products have few differentiating features. Also, companies may try to augment spreads by using less liquid, more exotic asset classes, which present additional investment risks.

The greater an insurer's exposure to these institutional liabilities, the greater the stress on an insurer's liquidity profile, especially in certain situations such as a rating downgrade or a contract containing negative covenants. Further, if an insurer has a large portion of its total liabilities due in a year or less, it is substantially exposed to any material negative turn in investors' sentiment, which may cause a "run-on-the-bank" scenario that damages franchise value and deters investors.

Put options embedded within FAs give rise to liquidity concerns and event risk. FA providers must employ effective asset/liability management techniques, model the quick roll-off of puttable FAs and maintain adequate sources of liquidity. The longer the duration of an insurer's asset portfolio, and the lower the quality, the less likely it is that the company will be able to handle a “run-on-the-bank” scenario where a significant portion of assets potentially would need to be divested at a loss.

For FAs that do not have puts, which is current market practice, rollover (refinancing) risk is an issue. Similar to debt obligations, as FAs mature principal payments must be made. If cash flows are not realized through a new note issue or GIC sale, assets may need to be disposed of (at a less than opportune time) to satisfy the maturing obligation. To be clear, insurers issuing FAs within FABS programs do not necessarily also offer puttable FAs. While there is rollover risk at maturity, a block of FAs securing a note issuance program is generally more stable and predictable than a block of short-term puttable FAs.

The FABS market is not “self-policing” like the commercial paper market, where outstanding paper may be left to mature on schedule (assuming “normal” markets). An orderly roll-off of an insurer's FA liabilities may not be possible since the exercise of outstanding put options is unpredictable. Although the use of reinsurance is atypical in the FA marketplace, A.M. Best must monitor its usage and incorporate it into its overall analysis.

5. Risk Reduction Techniques

A.M. Best analysts will look for certain risk-reduction techniques, including the following:

- Cash-flow matching
- Diversification of assets
- Laddered liability maturities
- Surplus and capital backed with liquid assets
- Back-up line of credit
- Commercial paper facilities
- Repurchase agreements
- Liquidity options from an investment dealer

Rating Process

In addition to holding discussions with the insurer to assess the transaction's structure, economics and modeling of the FA's future performance, A.M. Best may obtain and review documentation for each program, including:

- Offering memorandum, term sheets and indenture
- Operative documentation of the funding agreement
- Documentation of third-party credit support (if applicable)
- Legal opinions of the FA and SPV
- Regulatory actions and communications on any significant aspect of the FA or SPV.

When the analytical team has received all the necessary information and documentation, conferred with all relevant parties and completed their assessment, the team will recommend a rating to the rating committee.

Maintaining the rating requires the insurer to provide A.M. Best with periodic updates on its FABS programs, timely notice of material changes in the performance of the assets backing the FA, and notice of any regulatory actions that have the potential to materially affect the transactions.

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METHODOLOGY

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Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

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