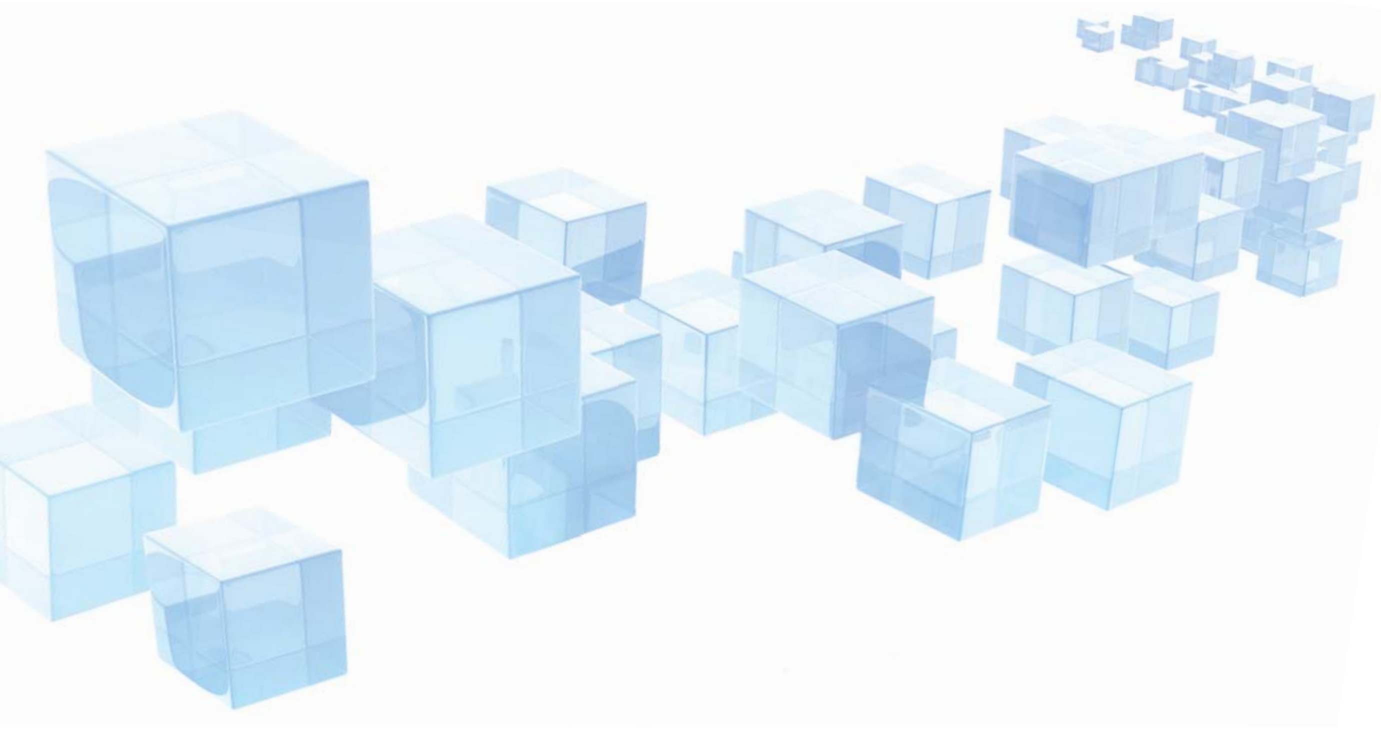
BEST'S METHODOLOGY AND CRITERIA

Rating Funding Agreement-Backed Securities Programs

October 13, 2017



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A.M. BEST®

Rating Funding Agreement-Backed Securities Programs

Outline

A. Market Overview
B. Rating FABS Programs

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of A.M. Best Rating Services' rating process.

A. Market Overview

This criteria procedure describes A.M. Best's approach to rating funding agreement-backed securities (FABS) programs; within these programs, the notes to be rated are secured by funding agreement (FA) contracts issued by U.S. life insurers. A.M. Best may rate both a FABS program and a particular series of notes (tranches) within each program. A FABS program rated by A.M. Best would be assigned an Issuer Credit Rating (ICR), while the various tranches would be assigned Issue Credit Ratings (IR).

Funding Agreements (FAs)

In broad terms, FAs are nonqualified annuities or annuity-like instruments that can be used 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). This structure transfers the credit quality of a policyholder claim at the insurance company to the notes of the SPV. FAs may be more appropriate than guaranteed investment contracts (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) typically are governed by New York law.

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.

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.

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, floating rate, or zero-coupon.

The Structure of a FABS Program

Within a FABS program, 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 SPV is needed to convert a non-tradable insurance product (the FA) into liquid investment products (the notes). The notes are a securitized instrument in that they pass along the proceeds of the FA in a structured manner. Hence, the FAs and the notes have analogous payment structures. 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. Where swaps or other derivatives are used, this creates an additional source of assets, as well as liabilities, for the SPV.

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 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.

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.

Usage of FABS Programs

For the insurers that have participated in institutional investment markets, FABS programs have been an attractive alternative to non-tradable GICs and FAs. 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.

B. Rating FABS 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.

Key Rating Factors

State Regulatory Opinions on Priority of FAs

A crucial issue in the analysis 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 and/or notes, all other factors being equal, would rank below that of the insurance 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.

FABS Structure

An important aspect of relating the insurer's ICR to the rating of the program and/or 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 considers: (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.

ALM and Liquidity Factors

FA providers must employ sophisticated asset liability management (ALM) 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 putable 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 the 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 putable 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 putable 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 monitors its usage as part of its overall analysis.

Risk Reduction Techniques

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 balance sheet strength assessment due to elevated operating leverage.

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, and
- Liquidity options from an investment dealer.

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 when (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 also 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. Credit-enhanced programs and/or notes may be assigned a higher rating than the insurer's ICR. These cases also are atypical.

Documentation

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.

Maintaining the program 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.

Published by A.M. Best Rating Services, Inc.

METHODOLOGY

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Oldwick, NJ

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Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

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 Credit 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).

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance and business profile or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services Inc., (AMBRS) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AMBRS.

Version 020116