

January 17, 2012

A.M. Best's Perspective On Operating Leverage

As part of forming an overall opinion of a company's balance sheet strength, A.M. Best reviews the organization's total leverage, which includes financial leverage and operating leverage. Financial leverage, through debt or debt-like instruments, may place a call on an insurer's earnings and strain its cash flow. Also, excessive leverage at the operating or holding company can lead to financial instability.

Operating leverage is broadly defined as leverage utilized in normal business operations (insurance or non-insurance) to support liquidity or to provide additional sources of operating income with tight duration or cash-flow matching characteristics. These activities also may be program specific (i.e., spread lending) or support non-economic reserves with low levels of liquidity risk, credit risk and duration mismatch risk. Regardless of its form, leverage may impact an insurer's liquidity, cash flow and operating profile and could lead to financial instability, particularly during times of systemic capital market distress.

Generally, the debt portion of an insurer's capital structure is utilized as working capital for its insurance lines. For organizations with debt-issuing holding companies, dividends from the insurance subsidiaries typically represent a major source of debt service. Diversified enterprises that possess significant non-insurance operations, such as consumer finance, asset management, equipment leasing and mortgage banking, may require additional funding. If the financing of other operations is to be serviced solely by the non-insurance businesses and meets the eligibility requirements outlined on the following pages, A.M. Best likely would consider the debt as operating leverage rather than financial leverage. These businesses usually are not guaranteed by the lead insurance company, and the debt typically is match-funded with corresponding assets such as credit card receivables or mortgages. However, for organizations with highly leveraged non-insurance operations, A.M. Best will consider extraordinary (i.e., wider) notching of debt securities issued by holding companies as well as the potential impact on the insurance company's ratings.

For organizations that issue debt or debt-like instruments directly from an operating insurance company, amounts eligible for operating leverage treatment generally would involve cases where residual risk to the insurer is insignificant. Because financial instruments may be issued either by holding companies or by operating companies (or by both), A.M. Best will apply specific tolerances at each operating company, as well as on a consolidated basis. If the tolerance is exceeded at an individual operating company/rating unit or in aggregate, A.M. Best would monitor closely the issuer's appetite for additional forms of leverage (for example, retail notes and/or institutional spread-based [ISB] products) and would contemplate lowering the entity's rating if growth trends vary substantially from previous expectations. (Please see **Step 1** on page 5 for operating company examples.) Ultimately, debt obligations viewed by A.M. Best as operating leverage would be excluded fully from the calculation of consolidated financial leverage, unless the tolerance level is exceeded. (Please refer to **Step 2** for a consolidated view.)

Analytical Contacts

George Hansen
+1 (908) 439-2200 Ext. 5469
George.Hansen@ambest.com

Rosemarie Mirabella
+1 (908) 439-2200 Ext. 5892
Rosemarie.Mirabella@ambest.com

Stephen Irwin
+1 (908) 439-2200 Ext. 5454
Stephen.Irwin@ambest.com

SR-2016-M-354

Eligibility for Operating Leverage Credit

A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets, finance non-insurance operations or fund non-economic reserves. Cash flows from the pool of assets should be sufficient to fund the interest and



principal payments associated with the obligations. Additionally, the insurer must possess sound asset/liability and investment risk management capabilities, adhere to low-duration mismatch tolerances, and maintain negligible repayment and liquidity risk related to these obligations. For financings to receive operating leverage treatment, A.M. Best must be able to (1) analyze the assets supporting these debt issuances to assess their credit risk along with any ALM mismatch risk; (2) understand management controls and the structure of the funding mechanism; (3) review specific provisions related to debt covenants. In addition, if leverage is part of a spread-based program, the company must be able to demonstrate positive spreads. Some examples of activities that typically would be viewed as operating leverage include:

- Securities lending programs
- Repurchase and reverse repurchase agreements (repos)
- Spread based Federal Home Loan Bank (FHLB) borrowings
- Guaranteed investment contracts (GICs) and funding agreements
- Funding agreement-backed securities programs (FABS)
- Retail note programs
- Premium financing operations utilized by property/casualty insurers
- Letters of credit (LOCs), debt or parental guarantees related to Regulation XXX or Guideline AXXX (XXX or AXXX) reserve financing
- Government programs that introduce leverage to an insurer's balance sheet
- Embedded value securitizations
- Other off-balance-sheet liabilities

Given that capital market financing solutions will continue to evolve, this listing is not meant to be exhaustive, and A.M. Best may review new forms of capital market financing on a case by case basis to determine as operating or financial leverage treatment based on its assessment of the underlying, fundamental characteristics.

With respect to closed-block monetizations, A.M. Best would tend not to view the debt associated with these transactions as operating leverage, particularly if the debt is with recourse. A.M. Best recognizes the stable, long-term nature of closed-block liabilities and the steady earnings generated by the assets supporting the business, along with the flexibility to reduce future dividends to meet closed-block liabilities. The impact on an organization's business profile of eliminating the closed block's future earnings and deploying the debt proceeds in higher risk, higher return businesses will be incorporated in the overall financial strength evaluation. However, A.M. Best's tolerance for financial leverage for that company likely would increase, depending on the characteristics of the in-force block.

Generally, securities lending programs maintain liquid, high-quality investments with tightly matched asset/liability durations and are governed by formal investment guidelines that have established limits for interest rate, reinvestment and counterparty risks. A.M. Best will continue to permit operating leverage treatment. However, should an insurer demonstrate over-reliance on securities lending or have a track record of incurring collateral-related losses, A.M. Best may disallow full operating leverage credit.

FHLB programs provide financial flexibility for insurance company members and are an attractive source of capital because of the low rates offered on advances. For companies that invest the loan proceeds in their core businesses for working capital, these obligations would be viewed as financial leverage. If FHLB borrowings are being utilized for spread enhancement activities (i.e., similar to external funding agreements in purpose) and the insurer can demonstrate strong asset/liability and liquidity management expertise, A.M. Best would view

these activities as qualifying for operating leverage treatment. The rationale for this is that these borrowings are similar to other ISB products such as GICs (general account, separate account and synthetic), funding agreements, FABS and retail notes. However, if FHLB programs are being used as working capital and/or as a liquidity or capital backstop, A.M. Best would view such borrowings as financial leverage, particularly longer term FHLB borrowings that are not being match-funded.

Another type of debt obligation that A.M. Best has treated as operating leverage is one that is a component of a securitization (e.g., debt issued to fund XXX and AXXX [non-economic] reserve redundancies). In these structures, the assets are segregated and placed in a Regulation 114 trust for the benefit of the policyholders. The cash flows generated are projected to be more than sufficient to fund the debt payments, i.e., the securitization structure typically contains some overcollateralization. Also, these structures regularly involve the issuance of debt that is nonrecourse to the direct writer through a special-purpose vehicle. Moreover, in recent years companies have increasingly utilized senior unsecured debt issuances to self-fund XXX and AXXX reserves. In this case, only debt issued by the holding company will be afforded 100% operating leverage credit. However, if there is some recourse to the issuer (i.e., a holding company issues unsecured debt but it contains a feature requiring the posting of additional collateral if the issuer's credit default swap [CDS] spreads widen), these types of issues will not be afforded full operating leverage credit.

In some cases, XXX and AXXX funding solutions have utilized LOCs to fund these reserves. These LOCs have rollover risk, which may increase an insurer's cost or may no longer be available during times of severe dislocations in the capital markets. A.M. Best will only consider full operating leverage treatment for LOCs that have a remaining maturity of five years or longer. If LOCs have near-term rollover risk (i.e., less than five years), they will be considered financial leverage. Some regulators are permitting the utilization of holding company guarantees to XXX and AXXX captives in lieu of external financing. In these instances, A.M. Best will qualitatively incorporate these holding company guarantees as part of its operating leverage tolerance.

A.M. Best has observed the increased use of embedded value transactions where a block of in-force business has been monetized through issuance of debt to external investors backed by an SPV structure. If such transactions are non-recourse to the holding company, A.M. Best will generally treat these types of transactions as operating leverage. Those transactions containing some level of recourse to the holding company through a support agreement may be afforded some level of operating leverage, pending A.M. Best's review of the recourse features. However, should the holding company be required to remedy deficiencies (for any reason), any required funding will be treated as financial leverage.

Other Considerations

A.M. Best will employ a "look-through approach" for off-balance-sheet liabilities as disclosed in the financial statement footnotes in its calculation of operating leverage tolerance. One type of off-balance-sheet liability can arise from variable interest entities (VIEs), which are utilized for investment and asset management purposes. VIEs may or may not be consolidated on an insurer's balance sheet, depending upon whether or not the VIE is seen as a passive-type investment activity (i.e., nonconsolidated) or where the company is deemed a primary beneficiary of the VIE (i.e., consolidated). VIEs on an insurer's balance sheet will be reviewed qualitatively in an assessment of an insurer's operating leverage. If the VIE is consolidated and reflected as debt on the insurer's balance sheet, it will be removed from the financial leverage calculation, assuming that the debt is nonrecourse to the insurer and risk of loss is limited to the insurer's investment in the VIE.

Accordingly, A.M. Best typically would view financings resulting from the aforementioned activities as operating leverage if the insurer possesses strong asset/liability, liquidity and investment management skills, and if duration mismatch is kept to a minimum. In addition, nonrecourse debt would be viewed more favorably when calculating a company's financial leverage. For financings to receive operating leverage treatment in the financial leverage ratio calculation, A.M. Best must be able to (1) analyze the assets supporting these debt issuances, (2) understand management controls and the structure of the funding mechanism and (3) review specific provisions related to debt covenants. Moreover, A.M. Best will consider the potential volatility of the assets supporting the debt fundings, as well as prospective operating leverage at all rated insurance subsidiaries.

Operating Leverage Limits

A.M. Best views operating leverage-related activities as reasonable for highly rated companies with diverse lines of business, considerable expertise in asset/liability and investment management, and sufficient financial flexibility. However, the greater an insurer's exposure to these liabilities, the greater the potential stress on its liquidity profile, particularly in certain situations such as a rating downgrade or a contract containing negative covenants or adverse put options. A.M. Best expects consolidated and operating company leverage to be maintained at reasonable levels that reflect current capital market conditions. With respect to insurance operating company leverage, A.M. Best is most comfortable when operating leverage activities such as institutional investment products and spread lending do not constitute a large proportion of general-account liabilities.

A.M. Best has developed specific guidelines for each rated statutory insurance operating company of a group and all statutory insurance operating companies combined (statutory view; see **Step 1**). In short, A.M. Best would be uncomfortable with a statutory entity or group if the sum of ISB product liabilities, retail notes outstanding, liability for securities lending and FHLB loans exceeds 50% of general account "reserves". As mentioned previously, A.M. Best would monitor closely the issuer's appetite for these products and contemplate lowering the entity's ratings if growth trends vary substantially from previous expectations.

A.M. Best also will perform a test at the consolidated holding company level (GAAP basis; see **Step 2**) to determine the full impact of operating leverage treatment on an organization's published debt-to-capital ratio. Credit for operating leverage will be reduced if the sum of activities qualifying for operating leverage (see above examples) exceeds 30% of consolidated (GAAP) liabilities, excluding separate-account liabilities. Therefore, debt issued under qualifying operating leverage activities that exceeds this ratio will be subject to treatment as financial leverage in A.M. Best's debt-to-capital calculations.

Finally, for analytical purposes, A.M. Best will consider the impact of this analysis on the organization's interest coverage ratios.

Operating Leverage Definitions and Examples

STEP 1

Example 1 - ABC Insurance Co.:

Product	Amt. O/S (\$ Millions)
GICs	-
FABS	-
FAs	3,600
Retail Notes	-
Securities Lending	1,000*
FHLB Borrowings	800
Total OCB	5,400
General Account (GA) Reserves (Annual Statement lines 1-6.3)	9,000
OCB/GA Reserves	60%

This exceeds A.M. Best's 50% tolerance for a statutory entity. Hence, A.M. Best would closely monitor the company's appetite for these products and contemplate lowering the issuer's stand-alone rating if growth trends vary from A.M. Best's expectations.

Example 2 - XYZ Insurance Co.:

Product	Amt. O/S (\$ Millions)
GICs	400
FABS	1,400
FAs	200
Retail Notes	-
Securities Lending	950
FHLB Borrowings	650
Total OCB	3,600
General Account (GA) Reserves (Annual Statement lines 1-6.3)	10,000
OCB/GA Reserves	36%

This does not exceed A.M. Best's 50% tolerance for statutory entities.

Operating Company Borrowings (OCB) = GICs, FABS, funding agreements (FAs), retail notes, securities lending and FHLB advances

Total Balance Sheet Leverage = Consolidated balance sheet debt-to-capital ratio (unadjusted)

Financial Leverage = Debt-to-capital ratio assuming full operating leverage credit

Total Operating Borrowings = Operating company + Holding company operating borrowings (i.e. Operating Corporate Debt)

Composition Ratio = Total Operating Borrowings/Consolidated GAAP liabilities less separate-account liabilities

Adjusted Financial Leverage Ratio = Ratio that reflects the financial leverage + any operating leverage amounts exceeding the holding company tolerance

STEP 2

Example 1 - ABC Holding Co., Inc.:

Balance Sheet Item	Amt. (\$ Millions)	
Short-Term Debt	600	
Long-Term Debt	1,500	
Oper. Corp. Debt	1,000*	
Total Debt	3,100	
Total Equity	7,900	
Total Capital	11,000	
Total GAAP Liabilities	25,000	
Total OCB	5,400	
Total Operating Borrowings	6,400	(5,400 + 1,000)
Total Balance Sheet Leverage	28%	(3,100/11,000)
Financial Leverage	21%	(3,100-1,000)/ (11,000-1,000)
Composition Ratio	26%	(< 30%)
Tolerance	7,500	(.30)(25,000)
Amount Exceeding Tolerance	-	(6,400-7,500)
Adjusted Financial Leverage	21%	(3,100-1,000)/ (11,000-1,000)

For analytical purposes, this group's financial leverage ratio will reflect full credit for \$1 billion in operating leverage (*)

Example 2 - XYZ Holding Co., Inc.:

Balance Sheet Item	Amt. (\$ Millions)	
Short-Term Debt	600	
Long-Term Debt	1,500	
Oper. Corp. Debt	2,300**	
Total Debt	4,400	
Total Equity	5,600	
Total Capital	10,000	
Total GAAP Liabilities	15,000	
Total OCB	3,600	
Total Operating Borrowings	5,900	(3,600 + 2,300)
Total Balance Sheet Leverage	44%	(4,400/10,000)
Financial Leverage	27%	(4,400-2,300)/ (10,000-2,300)
Composition Ratio	39%	(> 30%)
Tolerance	4,500	(.30)(15,000)
Amount Exceeding Tolerance	1,400	(5,900-4,500)
Adjusted Financial Leverage	38%	(4,400-2,300+1,400)/ (10,000-2,300+1,400)

For analytical purposes, this group's financial leverage ratio will reflect partial credit (\$0.9 billion) for its \$2.3 billion in operating leverage (**)

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

METHODOLOGY

A.M. Best Rating Services, Inc.
Oldwick, NJ

CHAIRMAN & PRESIDENT Larry G. Mayewski
EXECUTIVE VICE PRESIDENT Matthew C. Mosher
SENIOR MANAGING DIRECTORS Douglas A. Collett, Edward H. Easop,
Stefan W. Holzberger, James F. Snee

WORLD HEADQUARTERS
1 Ambest Road,
Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
Paseo de la Reforma 412,
Piso 23,
Mexico City, Mexico
Phone: +52 55 1102 2720

LONDON
12 Arthur Street, 6th Floor,
London, UK EC4R 9AB
Phone: +44 20 7626 6264

DUBAI*
Office 102, Tower 2,
Currency House, DIFC
P.O. Box 506617,
Dubai, UAE
Phone: +971 4375 2780

*Regulated by the DFSA as a Representative Office

HONG KONG
Unit 4004 Central Plaza,
18 Harbour Road,
Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
6 Battery Road,
#40-02B,
Singapore
Phone: +65 6589 8400



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., (AMBR) 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 AMBR.

Version 020116