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Best's
Methodology and Criteria

Rating Closed-Block Monetizations

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Outline

The following criteria procedure should be read in conjunction with *Best's Insurance-Linked Securities & Structures Methodology (BILSM)* and all other related BILSM-associated criteria procedures. The BILSM provides a comprehensive explanation of AM Best' rating process for insurance-linked securities and insurance-linked structures.

A. Market Overview

Competitive pressures on earnings and capital adequacy drive how life insurers manage and allocate their assets. This is especially true for demutualized life insurers, which face demands from shareholders for better returns on equity. It is for these reasons that some publicly traded life insurers consider the monetization of future cash flow from closed-blocks of life insurance and annuities.

A closed-block is a segregated group of policies and contract obligations, along with the assets backing them. The block, which is in runoff, is considered "closed" because no business flows into it except for renewal premiums and it continues until the last policy is no longer in force. Monetization allows the insurer to receive immediate or upfront cash from investors in exchange for future earnings (i.e., the remaining cash flow after policyholder obligations in a closed-block are satisfied) on the closed-block of business.

Insurers may decide to monetize all or a portion of the expected cash flow. In theory, the cash proceeds from closed-block investors are redeployed to other businesses or investments that generate higher returns than the historically low return on capital generated by the closed-block business. A life insurer might set up a closed-block of policies in the course of demutualizing, converting from mutual ownership to a stock form of ownership, or as a means of exiting a line of business. For a demutualizing insurer, the closed-block is a way to protect the interests of its pre-existing policyholders (the insurer's former owners) from the competing interests of the stockholders (its new owners).

This criteria procedure provides transparency on how AM Best assigns ratings to the notes that are issued to investors and serviced by the cash flows from a closed-block monetization. The underlying creditworthiness of the insurer, as measured by its Best's Credit Rating, is one of the key drivers of the rating assigned to the monetization's notes. When assigning a Best's Issue Credit Rating (IR) to notes, the analysis focuses on the evaluation of the following:

- Whether the insurer is sufficiently profitable and well capitalized to pay dividends

- Whether the closed-block produces sufficient cash flow to pay principal and interest on the notes
- Whether the transaction structure captures all relevant proceeds, cash flows, collateral and guarantees securing payment of the notes

Structure of a Closed Block Monetization

Monetization differs from securitization in that the latter involves a transfer of the relevant assets to a bankruptcy-remote entity. In a monetization, the pledged assets, the surplus cash flow from the closed-block and the closed-block itself, remain with the insurer and are potentially available to satisfy all policyholder obligations in the event of insolvency. In that case, insurance regulators can release the closed-block assets to meet the insurer's obligations to policyholders. Thus, the claims of the noteholders to the closed-block business are subordinate to policyholders of the closed-block and the ongoing businesses.

Although the closed-block business is not a separate legal entity, the insurer typically prepares separate financial statements for it. It is important to emphasize that the separation of the closed-block business from the rest of the insurer's business is notional only. The monetization process allocates adequate assets to the closed-block to fund all insurance benefits, policyholder dividends and taxes. To simplify the regulatory monitoring of the closed-block, the expenses of administering it sometimes are paid from the insurer's ongoing business. Alternatively, expenses may be allocated by formula between the closed-block business and the insurer's ongoing business.

The closed-block business consists of two layers:

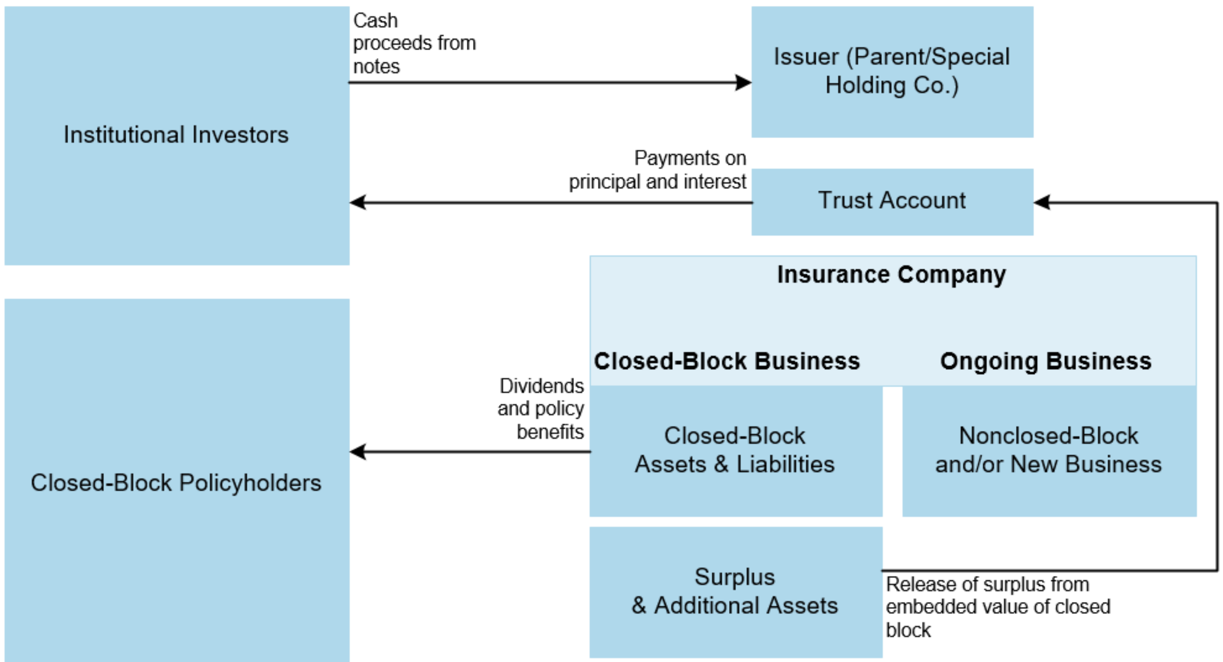
- The assets and liabilities designated as constituting the closed-block
- The surplus and additional assets

The insurer selects the assets in the closed-block with the intention that they will be sufficient to fund exclusively the liabilities of the closed-block. However, in stress situations, those assets can be loaned to the insurer's ongoing business or released by regulators.

The "surplus and additional assets" that reside outside the closed-block, but within the closed-block business, provide additional funds necessary to support the closed-block for potential shortfalls in the closed-block.

Although a closed-block can have a life span as long as 100 years or more, the securities issued against it can be structured with a much shorter maturity of 15 to 30 years. After the notes are retired, any excess cash flow still being generated by the closed-block can be monetized, or remonetized, at any point during the life span of the underlying policies.

Exhibit A.1: A Monetization's Cash Flow



In a closed-block transaction, cash flows pass from the closed-block to investors, through a separate entity related to the insurer. This entity, or issuer, is generally an intermediate holding company created by the parent for the purpose of issuing the notes and servicing the monetization. Typically, the issuer may also establish a trust account (trust) to ensure that the cash flows for the current period are funded sufficiently.

The trust holds the funds for payments of principal and interest and other collateral for the noteholders' benefit. The trust continues as long as any notes remain outstanding. The trust also can hold a portion of the proceeds of the notes as collateral for the notes. Funds are withdrawn from the trust for payments of principal and interest on the notes, and for any other expenses of the transaction, including premiums to bond insurers, investment management expenses and amounts due under interest-rate swaps related to the notes. If the assets in the trust fall below a predetermined level, the noteholders may have the right to accelerate the maturity of the notes.

The release of surplus and additional assets through dividend payments to the issuer, which is deposited in the trust, as well as the earnings on the funds in the trust, comprise the primary sources of funds to pay the interest and principal on the notes. Because of regulatory limitations on how much the insurer can pay in dividends to the issuer, the amount of funds available to noteholders reflects the insurer's overall performance, including the closed-block and ongoing businesses. Therefore, even if the closed-block outperforms expectations, generates more cash than projected, the funds available for dividends might decrease because the insurer as a whole underperformed.

As stipulated under state insurance laws, the exact amount of funds available for dividends to the intermediate holding company or issuer and payment to investors are determined by the insurer's operating performance in the preceding year, or by its capital and surplus at the end of that year. As a result, the underlying creditworthiness of the insurer, as measured by its Best's Credit Rating, is one of the key drivers of the rating assigned to the monetization's notes.

Upon the issuance of notes, the issuer receives a secured but limited-recourse loan from investors. Should investors need to enforce their security interest in the closed-block cash flow, their recourse would be limited to the surplus cash flow from the closed-block and any additional collateral in the trust, which can include stock in the insurer, swap agreements and tax-sharing benefits.

B. Rating Considerations

The IR assigned to the closed-block notes reflects the liquidation priority of the supporting assets in the event of an insurer's impairment or insolvency and ongoing recourse that exists to the general account. The rating analysis centers on three key issues:

1. Insurer financial strength
2. Adequacy of cash flows
3. Transaction structure

Insurer Financial Strength

A closed-block remains a part of the insurer, so the rating for the notes issued in the monetization bears a close relationship to the insurer's credit rating. However, a third-party guaranty, in whole or in part, of any aspect of the structure may support a higher rating than the insurer's rating.

The insurer's overall earnings will affect the amount of the dividend that becomes available to noteholders. Additionally, the monetization and resulting notes may create new risks that may affect the insurer's performance, which AM Best will incorporate into the analysis of an insurer, as described in *Best's Credit Rating Methodology,* which provides a comprehensive explanation of AM Best's rating process.

An insurer's inadequate operating performance could prompt a downgrade, which could depress earnings and ultimately affect dividends. Other business risks are considered, such as the potential for a decline in sales should certain products lose their tax-favored status.

With a view to identifying the risks that could affect the insurer's performance, AM Best reviews a variety of factors, including:

- The insurer's structure and relationships among the various entities in the larger organization
- Business strategy and management's proven ability to implement it
- Planned use of the note proceeds

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Insurer's Structure

The overall entity's corporate structure, of which the insurer is a part, as well as the relationships among affiliates, is analyzed to assess the organizational risks that could affect the monetization's execution. Such risks, for instance, might derive from financing agreements that are unrelated to the transaction but carry the potential to trigger an event of default under the monetization or another financing.

Should the insurer become insolvent, its policyholders in the closed-block as well as new policyholders, and direct creditors have a direct claim on the insurer's surplus and additional assets. The noteholders' claim to surplus and additional assets, by contrast, is indirect and subject to whether the insurer will release the excess cash as a dividend to the issuer from the closed-block.

Business Plan and Use of Proceeds

An insurer generally seeks to monetize the future cash flows of a closed-block to reinvest the proceeds at higher returns than the business in the closed-block is generating. Accordingly, the rating analysis considers the viability of any related business plans and the likely return on that investment. Support for this assessment is derived from discussions with management and the management's experience and capacity to execute the strategy.

AM Best also assesses the direct effect that the transaction will have on the insurer's cash flows that are pledged to secure the notes.

Adequacy of Cash Flows

The performance of the closed-block business ultimately determines the cash flow it produces. Dividends paid by the insurer attributable to this cash flow constitute the primary source of funds to service the notes.

A key issue is the rate at which surplus and additional assets become available to repay debt. AM Best assesses these elements as part of its analysis:

- Regulatory and legal issues
- Cash-flow risks and actuarial valuations

Regulatory and Legal Issues

A review of regulatory and legal issues regarding the closed-block business is essential in evaluating the risk of cash shortfalls in servicing the notes.

AM Best reviews the efficacy of the structures and accounting procedures. The policies, assets and cash flows of the closed-block business should be identified as pertaining to the structure, and there should be no material release of funds from it except by regulatory authority. AM Best also looks for sound documentation of appropriate investment guidelines; risk management procedures; financial reporting requirements; conditions to be met prior to execution of the transaction; and covenants pertaining to these items throughout the transaction's life.

A closed-block is subject to the oversight of state insurance commissioners. The potential exists for regulatory action to limit the funds available for dividends and application to the notes. For instance, regulators could block the release of the closed-block surplus if actual performance appears to be falling short of the projected "glide path" of the closed-block. The glide path is the difference between the assets and liabilities in the closed-block. To understand whether regulatory risk is likely to be realized, AM Best will review communications between the regulators and the insurer, as well as any related legal opinions.

Cash-Flow Risks and Actuarial Valuations

To understand the cash-flow risks at both the insurer and issuer levels, AM Best assesses the expenses and starting assets of the closed-block, as well as the closed-block's operating rules and the insurer's past approach to managing policy dividends.

The developing experience of the closed-block business ultimately determines the cash flow available to service the notes. If the policies in the closed-block are life insurance, the major risks to performance are mortality, surrenders and lapses. These risks are influenced by the types of policies, average age of the insureds, distribution of policy sizes, location of the policies issued, reinsurance and the insurer's underwriting procedures. With annuities, the primary risks are the longevity of the annuitants and changes in interest rates and investment markets. To the extent that these risks behave differently than assumed, the assets might be inadequate to support the block.

AM Best reviews the glide path of the closed-block by investigating the insurer's statutory financial statements; history of policy dividends; actuarial valuations for the closed-block since formation; and stochastic and other modeling of the block's future performance. Actuarial models assess the consequences of variations in mortality, lapsation, interest rates and credit risk. Accordingly, these model assumptions are reviewed for reasonability and then stress tested.

Reinsuring the policies within the closed-block presents the insurer with the counterparty credit risk of the reinsurers. Consequently, AM Best will consider their aggregate creditworthiness. Additional reinsurance risk may also be introduced from other dynamics. For instance, if the experience on the closed-block were to deteriorate, its reinsurers could increase their premiums, thereby increasing the operating expenses of the closed-block.

The assets allocated to the closed-block as well as the surplus and additional assets are analyzed for their quality and sufficiency to fund the closed-block's liabilities over its life. It is important that the funding calculations reflect the operating rules of the closed-block. Reviews will cover the insurer's processes for managing assets to liabilities in the general account as a whole and, if available, specifically for the closed-block business.

Reserves generally are invested in fixed-income securities, which present credit and interest-rate risks. Changes in interest rates and credit losses may affect the profitability of a closed-block. Undertakings by third parties can reduce this risk either overall, by guaranteeing the notes directly, or indirectly, such as through credit-default swaps on the invested assets.

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Transaction Structure

A closed-block monetization is a complex legal structure with a number of participants. The integrity of the monetization relies in large part on the priority of the noteholders' claim to the collateral in the trust account. The notes represent senior secured debt of the obligor, though the noteholders generally have recourse only to the collateral in the trust. Accordingly, structural risk is an important area of inquiry. To evaluate this, AM Best reviews:

- Regulatory and legal opinions
- Guarantees and other insurance agreements

Regulatory and Legal Opinions

There is a risk to investors if the monetization has been structured improperly. AM Best reviews any legal and regulatory opinions relating to the closed-block monetization, such as regulatory approval for the formation of the issuer and effective segmentation of assets. Factored into the rating is AM Best's view of the likelihood that the transaction's structure, which includes all relevant collateral and guarantees, will be sufficient to make debt service payments on the notes. Finally, the structure must be viewed in the context of all other debt documentation of the insurer and its affiliates.

The analytical focus is on the quality, amount, availability and management of the collateral in the trust account and the "perfection of the security interest" in it. Reviews will cover the creation of the trust, covenants on its management and, in particular, the priorities of the various parties' claims on the trust's assets in stress situations.

Guarantees and Other Insurance Agreements

If a third party, such as a monoline financial guarantor, is providing assurance of an aspect of the monetization, AM Best reviews the guarantor's credit quality, financial strength, and the documentation of its undertaking. The credit quality analysis includes a review of public information and discussions with the guarantor on its underwriting analysis of the transaction.

The notes are illiquid, as they typically aren't registered with the Securities and Exchange Commission, and no established trading market exists for them. This is an investment risk not covered in the rating opinion.

C. The Assignment of a Rating

When assigning an IR to the notes that are issued as part of a closed-block monetization, AM Best reviews the financial strength of the insurance entity that houses the closed-block, the adequacy of the cash flows to service the notes, and the structure of the transaction. A higher rating than the insurer's rating may be assigned if there is a third party guarantee.

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METHODOLOGY AND CRITERIA

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