

February 23, 2012

Analyzing Contingent Capital Facilities

A primary concern for an insurance organization is its need to maintain an amount of capital that is commensurate with the entity's risk profile. For companies with strong balance sheets, robust earnings and limited opportunities for growth, effective capital management may involve returning a portion of that capital via stock buy-backs or the retirement of debt. While A.M. Best does not advocate aggressively removing capital from the balance sheet, too much capital can be problematic in that it exerts pressure to grow and expand operations at a pace that may not be prudent under certain market conditions.

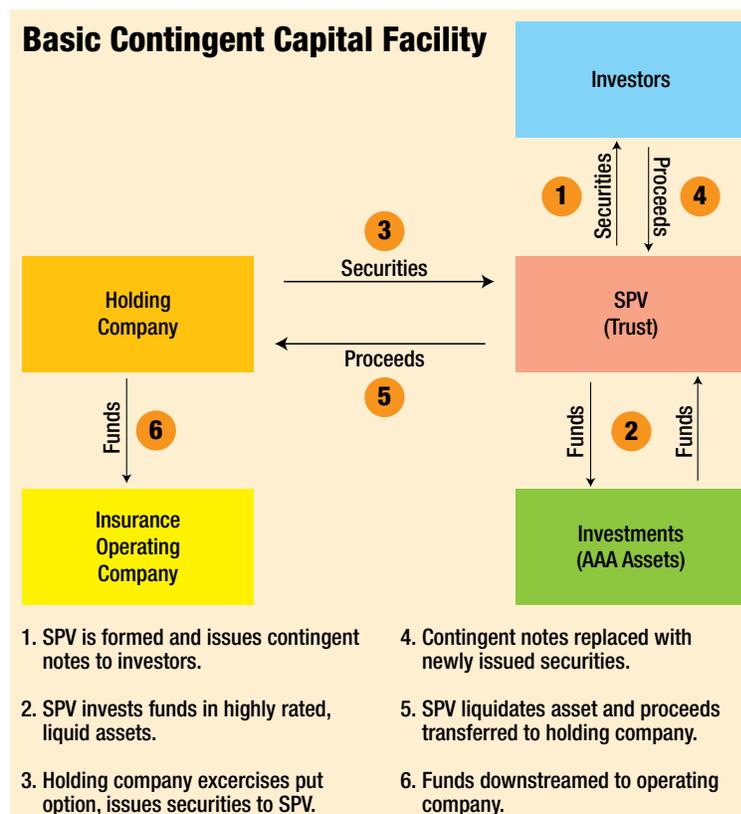
During periods when the market is flush with capital, stock buy-backs become a popular mechanism for companies to achieve an appropriate balance between capital and risk. However, with a diminished capital cushion, management teams become concerned with their ability to take advantage of future market opportunities. A favorable business opportunity such as an acquisition or new line of business may not wait for the company to raise capital. Moreover, under a shock-loss scenario such as a catastrophe, companies may find it difficult to recapitalize afterward at a reasonable cost. This refers to the concept of financial flexibility, which goes hand in hand with capital management and is a key component of A.M. Best's rating analysis.

Credit for Contingent Capital Facilities

Some management teams have taken proactive steps toward enhancing their financial flexibility. One popular approach is through contingent capital facilities, which allow

companies to preset the terms and conditions of future capital-raising initiatives. Based on the provisions of the facility, A.M. Best will consider giving qualitative and, in some cases, quantitative credit for contingent capital. It should not be inferred, however, that A.M. Best expects all highly rated companies to maintain contingent capital facilities. This is simply one of many ways insurance organizations can demonstrate their financial flexibility.

Considering the recent interest in contingent capital, A.M. Best has determined which provisions likely would



Analytical Contacts

Carlos Wong-Fupuy
+44 2(0) 7397 0287
Carlos.Wong-Fupuy@ambest.com

Ken Johnson, CFA, CAIA, FRM
+1 908 439 2200 Ext. 5056
Ken.Johnson@ambest.com

Michael Lagomarsino, CFA, FRM
+1 908 439 2200 Ext. 5810
Michael.Lagomarsino@ambest.com

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

SR-2008-M-129a



warrant credit in Best's Capital Adequacy Ratio (BCAR), which measures risk-adjusted capital available to meet policyholder obligations. Generally, more credit is given to fully funded facilities, where the special-purpose vehicle (SPV) holds highly rated, liquid securities that the sponsor can access on short notice. A.M. Best also looks favorably on facilities that require put options to be exercised when certain events occur, such as a catastrophe loss (i.e. natural, man-made or pandemic). If the put option rests with the holding company, credit is given if the holding company is obligated contractually to downstream the funds to its insurance operating subsidiary. In cases where the put option involves a hybrid issuance at the operating company level, the maximum available credit would be 90%. This could reach 100% if the facility involves the issuance of equity securities. However, since limitations are placed on all forms of soft capital, in cases where credit is given in the published BCAR model, the maximum credit allowance is 10% of equity capital. Also, where credit is given on a pro forma basis – that is, prior to exercising the put option – the securities to be issued pursuant to the contingent capital facility will count toward the financial leverage calculation.

Facilities that do not conform to these specifications (i.e. the SPV is not fully funded; triggering the facility is subject to management discretion) still can receive credit on a qualitative basis, and on a quantitative basis toward the stress-tested capital requirement. Here, the securities to be put to the SPV would not count toward the financial leverage calculation until actually

issued. The cap on credit given in the stress-tested BCAR would be increased to 35% of equity capital.

Conclusion

Contingent capital facilities provide companies with financial flexibility and protect the balance sheet against the unexpected. Alternatively, they can enable a company to seize a market opportunity in a timely fashion, without first having to test the appetite of the capital markets. Plus, they allow a company to establish the terms and

Case Study – Treatment of Contingent Capital Facility

Holding Company Capital Structure

Debt	\$600
Hybrid	\$200
Equity	\$1,800
Total Capital	\$2,600
Contingent Capital	\$400*

*operating company has put option to issue a hybrid security

Operating Company BCAR Treatment

Assuming facility meets guidelines for receiving credit in BCAR (see Table).

	Baseline	Add Contingent Capital Credit
Adjusted Capital	\$2,8001	\$3,0603
Required Capital	\$2,0002	\$2,0504
BCAR Score	140	149

1 Adjusted Capital – Baseline: Starting Equity Capital is \$2600 (assumes all holding company capital downstreamed as equity to operating subsidiary) plus Adjustments totaling \$200 (loss-reserve equity, fixed-income equity, deduction for after-tax net PML) = Adjusted Capital of \$2800.

2 Required Capital based on the risk profile of the company.

3 Figure reflects addition of \$260 (90% of \$400 from contingent capital hybrid issuance is \$360; subject to cap of 10% of equity capital = \$260).

4 Required Capital with Contingent Capital Credit includes additional investment risk of new assets.

Financial Leverage Treatment

Assume security issued via contingent capital facility qualifies as a hybrid and gets 90% credit – subject to 20% total capital cap (\$600).

Unadjusted for Equity Credit

Debt + Hybrid + Contingent/Total Capital	$600+200+400/3,000 = 40\%$
--	----------------------------

Adjusted for Equity Credit

Debt + Hybrid charge + Contingent charge/Total Capital	$600+20+40/3,000 = 22\%$
--	--------------------------

20% cap on equity credit not applicable because $\$540 < \600 .

conditions of future capital-raising activities up front, which reduces the chances of having to pay a risk premium under adverse conditions.

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., (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