

June 16, 2011

Best's Idealized Default Rates of Insurers*

On the Credit Market Scale.

	1-Year	3-Year	5-Year
aaa	0.03%	0.20%	0.45%
aa+	0.06%	0.58%	1.10%
aa	0.11%	0.76%	1.41%
aa-	0.16%	0.95%	1.71%
a+	0.21%	1.13%	2.02%
a	0.23%	1.25%	2.25%
a-	0.27%	1.51%	2.75%
bbb+	0.67%	3.18%	5.46%
bbb	1.20%	5.23%	8.91%
bbb-	2.30%	8.10%	13.31%

* Derived from Best's Idealized Default Matrix published Dec. 12, 2007.
Source: A.M. Best Co.

Best's Idealized Default Rates of Reinsurers*

On the Credit Market Scale.

	1-Year	3-Year	5-Year
aaa	0.03%	0.26%	0.56%
aa+	0.06%	0.74%	1.36%
aa	0.12%	1.09%	1.93%
aa-	0.33%	1.61%	2.72%
a+	0.54%	2.13%	3.51%
a	0.70%	2.39%	3.98%
a-	0.88%	2.80%	4.72%
bbb+	2.94%	6.81%	10.35%
bbb	4.30%	10.02%	15.21%
bbb-	6.22%	14.04%	21.01%

* Derived from Best's Idealized Default Matrix published Dec. 7, 2007. Further adjustments were made to reflect the probability of distressed runoffs.
Source: A.M. Best Co.

Additional Information

Criteria:

Best's Impairment Rate and Rating Transition Study

A.M. Best's Idealized Default Matrix

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This criteria report can be found at
www.ambest.com/ratings/methodology

Securitization of Reinsurance Recoverables

Insurance companies purchase insurance to spread their risks and to limit their exposure to large or catastrophic losses. Reinsurance is a form of insurance for an insurance company. Under a reinsurance contract, the primary insurer transfers or "cedes" to another insurer (the "reinsurer") all or part of the financial risk of loss accepted in issuing insurance policies. The reinsurer, for a premium, agrees to indemnify or reimburse the ceding company for all or part of the losses the latter may sustain from claims it receives.

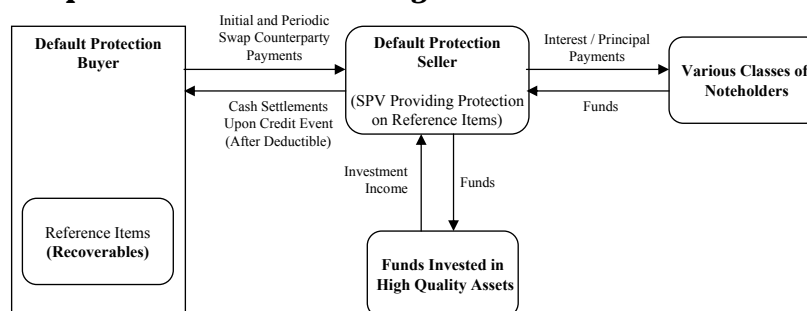
Reinsurance may be obtained from professional reinsurers (insurers that specialize in assuming reinsurance); reinsurance departments of primary insurance companies; or reinsurance pools. When reinsurers purchase reinsurance, the transaction is known as retrocession. For the purposes of this document, purchases of insurance by insurers or reinsurers from other insurers or reinsurers are referred to as reinsurance transactions.

A pool of reinsurance recoverables consists of the following components:

- Amounts due for claims and related expenses paid by the ceding company;
- An amount recoverable on the estimate of losses that have occurred and been reported, but have not yet been paid by the ceding company and related expenses;
- An amount recoverable on the estimate of incurred but not reported losses; and
- An amount equal to the portion of unearned reinsurance premiums paid to the reinsurer.

Given the size of reinsurance recoverables relative to surplus, uncollectible reinsurance can adversely affect insurance companies' financial strength.

Exhibit 1 Simplified Transaction Diagram



For this reason, insurers and reinsurers alike have been looking for ways to reduce their exposure to uncollectible recoverables and concentrations of exposure to specific reinsurers. One approach to achieving this goal is to securitize a portion of the reinsurance recoverable and pass the risk of uncollectible reinsurance to the capital markets. This risk transfer can be accomplished through the use of credit derivative and collateralized debt obligation (CDO) technology. This document describes A.M. Best's rating methodology for evaluating the securitization of reinsurance recoverables. It does not address the treatment of the securitization transaction in the Financial Strength Rating (FSR) process applied to the rating of insurers and reinsurers.

Basic Transaction Structure

Reinsurance recoverable securitizations typically involve credit derivative technology, such as a credit default swap (CDS), and a CDO as diagrammed in **Exhibit 1**. In the typical credit default swap, an organization (known as the default protection buyer) seeks protection from another entity (known as the default protection seller) for credit events that may occur with designated reference items. In this case, the reference items are the reinsurance recoverables on the balance sheet of the default protection buyer. The transaction documents define the credit events – conditions under which payments are to be made from the default protection seller to the default protection buyer based on the state of the reference items from a credit perspective. The credit events could be defined as bankruptcy of the entities backing the reference items; insolvencies; and any other indications that the reference items are impaired.

The transaction also looks like a CDO because the default protection seller, in the form of a bankruptcy-remote, special-purpose vehicle (SPV), borrows money from noteholders to fund the CDS in a structured transaction collateralized by a reference pool of items. The interest payments to noteholders are made from the proceeds of the swap counterparty payments made by the default protection buyer and the investment income generated by the funds from the noteholders, which are invested in high-quality securities. The CDO portion of the transaction is synthetic in the sense that

the reinsurance recoverables are not transferred to the SPV, and thus there is no “true sale.” To be more specific, the SPV does not own the reinsurance recoverables in the transaction as ordinarily would be the case with cash CDOs; it just references them.

The default protection seller is exposed to the credit risk of the default protection buyer. This credit exposure can be mitigated if the default protection buyer makes swap counterparty payments in advance. The default protection buyer may, in turn, be exposed to the credit risk of the default protection seller because it relies on the default protection seller to make cash settlements upon the occurrence of credit events.

The transaction outlined in **Exhibit 1** is considered to be partially funded in that the funds raised from noteholders are not sufficient to cover the absolute maximum amount of credit losses that the default protection buyer's reinsurance recoverables may experience.

The recoverables can be managed – that is, the composition of the recoverables can change based on some basic criteria as agreed upon at the inception of the transaction – or they can be static. If they are managed, the transaction document will describe the conditions under which the recoverables pool can be changed.

Credit Events and Default Assumptions

The definition of a credit event for reinsurance recoverables is critical to the determination of the aggregate credit risk inherent in the pool of reinsurance recoverables. The definition of a credit event that applies to non-insurance entities may not apply to insurers or reinsurers. For example, a credit event for an industrial company could be a shortfall in an interest or principal payment on its financial obligation such as a bond. This credit event normally would be classified as a default in the parlance of most rating agencies. Reinsurers, however, rarely show explicit evidence of default because under extreme financial duress, they often go into runoff and then enter commutation agreements to settle remaining liabilities with their cedants. The common practice of commutation means that it often is unclear whether default, as normally defined in the

Exhibit 2

Best's Cumulative Average Impairment Rates*

On the Financial Strength Ratings scale.

	1	2	3	4	5	6	7	8	9	10
A++/A+	0.06%	0.18%	0.33%	0.49%	0.64%	0.86%	1.09%	1.33%	1.63%	1.95%
A/A-	0.18%	0.55%	1.02%	1.50%	2.04%	2.62%	3.21%	3.86%	4.48%	5.05%
B++/B+	0.77%	1.80%	2.85%	4.18%	5.59%	6.81%	8.04%	9.02%	9.80%	10.63%

* Based on property/casualty and life/health data from 1977 to 2010; see *Best's Impairment Rate and Ratings Transition Study* for more information.
Source: A.M. Best Co.

credit markets, has taken place or not. This is because the cedant may be agreeing to a commutation to avoid the risk of the reinsurer becoming insolvent in the future, but other factors, such as the liquidity value of receiving the payment immediately or future uncertainty of the ultimate size of the claim, often influence commutation agreements. As commutations often take place privately between reinsurers and their cedants, it is difficult to tell whether cedants are getting fair price for allowing the reinsurer to sever the reinsurance contract.

To determine the likelihood of a credit event for insurance-related obligations, A.M. Best begins with its comprehensive insurance impairment studies, the latest of which is *Best's Impairment Rate and Rating Transition Study – 1977 to 2010*, published May 16, 2011. **Exhibit 2** shows data from this latest study for FSRs ranging from “A++” to “B+.”

It is important to note that A.M. Best's definition of impairment includes not only default, but also any type of publicly disclosed regulatory intervention in the operations of an insurance company such as supervision, rehabilitation, receivership, conservatorship, a cease-and-desist order, suspension, license revocation, administrative order and any other action that restricts a company's freedom to conduct its insurance business as normal. Thus the data in the impairment studies do not purport to represent pure default statistics on obligations to policyholders but represent a compilation of the most comprehensive information available in the insurance industry on the credit exposure faced by policyholders of insurance companies.

Using the data from the impairment studies, A.M. Best derived a table, shown in **Exhibit 3**, which is *Best's Idealized Default Rates of Insurers*. This exhibit shows the assumed

Exhibit 3

Best's Idealized Default Rates of Insurers

On the Credit Market Scale.

	1	2	3	4	5	6	7	8	9	10
aaa	0.03%	0.11%	0.20%	0.31%	0.45%	0.60%	0.77%	0.96%	1.15%	1.36%
aa+	0.06%	0.32%	0.58%	0.84%	1.10%	1.37%	1.64%	1.92%	2.20%	2.48%
aa	0.11%	0.44%	0.76%	1.08%	1.41%	1.73%	2.06%	2.38%	2.70%	3.03%
aa-	0.16%	0.56%	0.95%	1.33%	1.71%	2.09%	2.47%	2.84%	3.21%	3.58%
a+	0.21%	0.67%	1.13%	1.58%	2.02%	2.46%	2.88%	3.31%	3.72%	4.13%
a	0.23%	0.74%	1.25%	1.76%	2.25%	2.74%	3.21%	3.68%	4.13%	4.58%
a-	0.27%	0.89%	1.51%	2.13%	2.75%	3.37%	3.98%	4.58%	5.18%	5.76%
bbb+	1.20%	1.96%	3.18%	4.35%	5.46%	6.51%	7.51%	8.45%	9.34%	10.18%
bbb	1.20%	3.26%	5.23%	7.11%	8.91%	10.63%	12.26%	13.81%	15.28%	16.67%
bbb-	2.30%	5.28%	8.10%	10.78%	13.31%	15.71%	17.96%	20.09%	22.08%	23.95%

* Derived from *Best's Idealized Default Matrix* published Dec. 5, 2007.
Source: A.M. Best Co.

Exhibit 4

Conversion of Financial Strength Ratings to Issuer Credit Ratings*

Financial Strength Rating (FSR) (Traditional A.M. Best Scale)	Equivalent Issuer Credit Rating (ICR) (Credit Market Scale)
A++	aaa
	aa+
A+	aa
	aa-
A	a+
	a
A-	a-
B++	bbb+
	bbb
B+	bbb-

* Please see *A.M. Best's Ratings & the Treatment of Debt* for more information on the FSR to ICR translation.
Source: A.M. Best Co.

default rates for insurers by the issuer credit rating (ICR), which is based on the credit market scale (the scale most easily recognized by the capital markets) as opposed to the FSR scale. The translation of the FSR scale to the ICR is shown in **Exhibit 4**.

A.M. Best uses *Best's Idealized Default Rates of Insurers* in **Exhibit 3** as the basis for modeling the credit risk of primary insurers engaging in reinsurance business. The table can be adjusted, if warranted, based on the definition of a credit event in any given transaction. For example, if a credit event is

Exhibit 5 Best's Idealized Default Rates of Reinsurers*

On the Credit Market Scale.

	1	2	3	4	5	6	7	8	9	10
aaa	0.03%	0.14%	0.26%	0.40%	0.56%	0.73%	0.92%	1.14%	1.37%	1.61%
aa+	0.06%	0.41%	0.74%	1.06%	1.36%	1.66%	1.97%	2.28%	2.60%	2.93%
aa	0.12%	0.63%	1.09%	1.52%	1.93%	2.32%	2.71%	3.10%	3.51%	3.94%
aa-	0.33%	1.00%	1.61%	2.18%	2.72%	3.23%	3.72%	4.19%	4.66%	5.13%
a+	0.54%	1.36%	2.13%	2.84%	3.51%	4.13%	4.72%	5.28%	5.81%	6.33%
a	0.70%	1.55%	2.39%	3.20%	3.98%	4.73%	5.45%	6.16%	6.84%	7.51%
a-	0.88%	1.83%	2.80%	3.76%	4.72%	5.67%	6.63%	7.57%	8.50%	9.43%
bbb+	2.94%	4.92%	6.81%	8.62%	10.35%	12.00%	13.58%	15.10%	16.57%	17.99%
bbb	4.30%	7.23%	10.02%	12.67%	15.21%	17.63%	19.94%	22.16%	24.29%	26.34%
bbb-	6.22%	10.25%	14.04%	17.63%	21.01%	24.22%	27.25%	30.13%	32.87%	35.48%

* Derived from *Best's Idealized Default Matrix* published Dec. 5, 2007. Adjustments were made to reflect the probability of distressed runoffs.
Source: A.M. Best Co.

defined by a downgrade to “bbb-” or lower, the default threshold would be adjusted based on the ratings transition matrices tabulated in the impairment studies regularly conducted by A.M. Best.

For reinsurers, **Exhibit 3** is adjusted, as more fully described later, because A.M. Best believes that the small group of reinsurers in existence behaves differently than primary insurers from a credit risk perspective. As stated earlier, reinsurers in financial distress are prone to going into runoff. In addition, the perception that the rating floor for a reinsurer to remain viable as a risk-bearing entity is roughly between “a-” and “bbb+” means that reinsurance companies downgraded to “bbb+” or below are substantially more likely to go into runoff than primary insurers that are downgraded to those same levels. Of course, being in runoff does not necessarily mean that the credit risk of a reinsurer has deteriorated, but it can lead to aggressive computations, which can result in cedants not receiving fair price.

To derive a reasonable proxy for the credit risk of reinsurers (for the purposes of reinsurance recoverable securitization transactions), **Exhibit 5**, *Best's Idealized Default Rates of Reinsurers*, was created by adjusting the data in **Exhibit 3**. This adjustment was achieved by setting the credit event threshold to “bb+” and below. Specifically, a reinsurer default is deemed to have occurred if the rating of the reinsurer moves to “bb+” or

lower. The data used for the adjustment is from the ratings transition matrices tabulated for the insurance impairment studies. In essence, this adjustment reflects A.M. Best's view that a reinsurer with a “bb+” rating most likely will be in a state of distressed runoff. The result of this adjustment is that the default rate for reinsurers is higher for any given rating level than the default rate for primary insurers.

It is important to state clearly that a credit event as embodied in the impairment definition, and hence in the idealized default tables, does not consider an insurer's or reinsurer's willingness to pay its obligations. An insurer or reinsurer may be unwilling to pay on such obligations if there is a dispute regarding the interpretation of the reinsurance contract; a suspicion of fraud; or other significant issues that may arise at the time the reinsurance obligation is to be settled.

Recovery Assumptions

Available data are scarce concerning recoveries on insurance obligations. For one thing, in some jurisdictions, very few insurance companies issue debt, so using data from recoveries on corporate debt as a proxy for recoveries on insurance company obligations is not viable. In addition, recoveries on reinsurance recoverables from primary insurers versus from professional reinsurers can be different because in some jurisdictions, reinsurance obligations are subordinated to other types of

Exhibit 6 Best's Default Correlation of Recoverables*

	P/C Reinsurer	L/H Insurer	P/C Insurer	L/H Reinsurer
P/C Reinsurer	20%	10%	15%	10%
L/H Insurer	10%	15%	10%	15%
P/C Insurer	15%	10%	15%	10%
L/H Reinsurer	10%	15%	10%	20%

*P/C = property/casualty; L/H = life/health
Source: A.M. Best Co.

policyholder obligations. Therefore, recoveries may be lower on recoverables from companies engaged in both primary insurance and reinsurance than recoveries from professional reinsurance companies that engage strictly in reinsurance.

In a securitization transaction where recoveries are fixed, A.M. Best will use the fixed recovery amount embedded in the transaction's documentation. In assessing transactions where recoveries are not fixed, A.M. Best will consider quantitative and qualitative factors by:

- 1) Observing the percentage of insurance companies moving from non-investment-grade ICRs back to investment-grade ICRs and using this percentage as a proxy for recoveries.
- 2) Observing the historical data on reinsurer runoffs to see what portion were under real financial distress.
- 3) Reviewing any data on recoveries provided by the sponsor of the transaction.
- 4) Applying conservative stresses in cases where a significant line of business for the reinsurer is known to have substantial reserve deficiency.

Correlation

Like recoveries, default correlation among insurers and reinsurers is difficult to quantify. In a sense, all obligations issued by both insurers and reinsurers are correlated, especially during extreme catastrophic events. If the catastrophic events are sufficiently large, nearly all insurers will be under financial duress. Furthermore, the insurance/reinsurance chain complicates matters. For example, an insurer may cede business to a reinsurer, which then retrocedes to another reinsurer and so on.

An insurer may, in fact, reinsure business written by its reinsurers, thus creating a reinsurance spiral. Since a ceding company remains liable for all claims filed by its policyholders, before seeking reimbursement from its reinsurers, an insurer's continued solvency may be impaired if the reinsurance chain is disrupted.

A.M. Best will assign correlations between insurance/reinsurance entities ranging from 10% to 20% as shown in **Exhibit 6, Best's Default Correlation of Recoverables**. For a composite company that conducts business in both the property/casualty and the life/health sectors, A.M. Best will determine in which sector the company is to be categorized. The correlations are relatively high compared with those observed in the financial sector because of:

- 1) The insurance/reinsurance chain.
- 2) The fact that all the recoverable assets are from the insurance industry, and companies in the asset pool are generally large (compared with companies in other transactions that reference insurance/reinsurance obligations such as the insurance trust-preferred CDOs). They therefore invest in similar assets and take risks in similar lines of businesses (if they are in the same sector).

Applying Default Rates

A.M. Best aggregates all the reinsurance recoverables from companies in the same insurance group or organization. It then obtains the ICR of each of the companies in each group. If the companies in the group have different ratings, A.M. Best uses the lowest ICR in the group or uses the ICR of the dominant company in the group (if one exists) for assigning a default rate to the reinsurance recoverable. If an issuer is not rated by A.M. Best but is rated by another

Exhibit 7 Best's Idealized Default Matrix On the Credit Market Scale.

	1	2	3	4	5	6	7	8	9	10
aaa	0.03%	0.08%	0.14%	0.22%	0.31%	0.42%	0.53%	0.66%	0.79%	0.94%
aa+	0.03%	0.11%	0.20%	0.31%	0.45%	0.60%	0.77%	0.96%	1.15%	1.36%
aa	0.04%	0.13%	0.26%	0.41%	0.58%	0.79%	1.01%	1.25%	1.51%	1.79%
aa-	0.05%	0.23%	0.42%	0.62%	0.84%	1.08%	1.33%	1.58%	1.85%	2.13%
a+	0.06%	0.32%	0.58%	0.84%	1.10%	1.37%	1.64%	1.92%	2.20%	2.48%
a	0.11%	0.44%	0.76%	1.08%	1.41%	1.73%	2.06%	2.38%	2.70%	3.03%
a-	0.16%	0.56%	0.95%	1.33%	1.71%	2.09%	2.47%	2.84%	3.21%	3.58%
bbb+	0.21%	0.67%	1.13%	1.58%	2.02%	2.46%	2.88%	3.31%	3.72%	4.13%
bbb	0.23%	0.74%	1.25%	1.76%	2.25%	2.74%	3.21%	3.68%	4.13%	4.58%
bbb-	0.27%	0.89%	1.51%	2.13%	2.75%	3.37%	3.98%	4.58%	5.18%	5.76%

*From *Best's Idealized Default Matrix* published Dec. 5, 2007.
Source: A.M. Best Co.

rating agency, the ICR issued by that rating agency may be considered when assigning the default rate to the recoverable. Insurers or reinsurers that are in runoff and are not rated by A.M. Best will be assumed to be in default for modeling purposes. Reinsurance recoverables of Lloyd's entities will be consolidated. The default rate applied to this aggregated balance will be the default rate associated with the overall ICR of the Lloyd's market.

Modeling and Stress Testing

A.M. Best utilizes a proprietary CDO model to analyze the cash flows of a transaction and its ability to repay the rated note tranches. Because each reinsurance recoverable is modeled separately over the life of the transaction, A.M. Best requires specific information about the collateral pool such as the issuer names, the insurance groups to which the companies that issued the recoverables belong, and the ICR for each company. A copy of the most recent term sheet, rating agency presentations, swap agreements, and indenture and offering circular are required to model the credit risk of the transaction.

In general, the modeling and stress testing are done as follows:

1) Each reinsurance recoverable is assigned a cumulative default rate array (depending on ICR of the issuer) based on either *Best's Idealized Default Rates of Insurers (Exhibit 3)* or *Best's Idealized Default Rates of Reinsurers (Exhibit 5)*.

2) The default rate array, which represents cumulative defaults from year 1 to the term of the transaction, is converted to a marginal yearly default rate array.

3) A correlation is applied across all pairs of insurers/reinsurers according to the matrix in **Exhibit 6**.

4) The marginal yearly default is used to stochastically model the likelihood of default at each period assuming a binomial distribution of losses – either the issuer of the recoverable is in default or is not in default.

5) Recoveries are assigned to the defaults of each recoverable based on historical data, or on agreed-upon recovery figures disclosed to investors in the transaction.

6) Through a Monte Carlo simulation process, net losses on the reinsurance recoverables are calculated for each simulation, and losses to noteholders are tabulated.

Various stress scenarios are applied to the transaction, including: increased default rates applied to the recoverables; increased asset correlations; and reduced and delayed recoveries (if recoveries are not fixed in the transaction). In the end, the total loss frequency to noteholders is tabulated and compared with *Best's Idealized Default Matrix (Exhibit 7)* for the maximum rating on the securities. This matrix is the benchmark for all of A.M. Best's ratings on structured securities. Other considerations that may change the

rating dictated by the loss frequencies to noteholders include: the untested nature of reinsurance recoverables as an asset class in a securitization; the uncertainty surrounding the risk of default on payments (such as the uncertainty added by

disputes); the uncertainty surrounding asset default correlation; the risk inherent in the investment portfolio; the criteria for changing the composition of the recoverables pool; and the results of the stress scenarios applied to the transaction.

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Methodology

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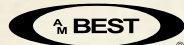
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