May 6, 2014

Insurance Holding Company And Debt Ratings

Insurance holding companies (IHCs) and their associated capital structures can have a significant impact on the overall financial strength of insurance company subsidiaries by providing subsidiaries with a level of financial flexibility via capital infusions, access to capital markets and, in some cases, additional cash-flow sources from other operations. Likewise, debt and other securities are typically obligations of an IHC, which, depending on the magnitude of these obligations, can reduce the financial flexibility of the enterprise and potentially place a strain on future earnings and inhibit growth in surplus at a subsidiary. This criteria report describes the approach for analyzing and rating IHCs and debt.

The analysis performed in the assignment of Best's Credit Ratings incorporates an assessment of material sources of risk to the rated entity, including the exposure to risk generated by activities at the parent/insurance holding company (IHC) and non-rated affiliates. Understanding the potential effect on a rated entity of the activities of the ultimate parent/IHC is integral to developing a comprehensive view of the rated entity's risk profile. As a result, all ultimate parents are reviewed and analyzed to determine, at a minimum, whether the parent's activities could reasonably be expected to place a call on the capital of the rated operating company, or expose the rated entity to material risk – even in cases where no public rating is assigned to the parent.

A.M. Best's fundamental rating approach for the assignment of any Best's Credit Rating is to examine an organization from both the top down and the bottom up. The foundation of the top-down analytical approach is the assessment of the IHC on a consolidated basis. A.M. Best's analysts also may assess the IHC on a parent-only basis to understand the parent's own direct activities. A.M. Best reviews the parent and consolidated entity to capture the entire group's performance, capital position, financial leverage, fixed-charge coverage, liquidity, asset quality and diversification, as well as other factors to ensure that the organization as a whole is in good financial standing. Also, if the IHC issues debt or hybrid securities to the public market, A.M. Best analyzes and may publicly rate these securities.

Metrics Applied to Analyze the IHC

Financial Leverage

When an insurer borrows at either the operating or IHC level, this changes its risk profile. To assess the level of debt within the capital structure, A.M. Best uses several financial leverage ratios that compare the level of debt to the level of capital. Accordingly, A.M. Best has developed guidelines for the impact of borrowing levels and servicing ability on an insurer's ratings. This analysis is part of the rating process, regardless of whether the insurer issues public debt (see **Exhibit 1**).

For complex organizations with multiple operating subsidiaries below an IHC, an analytical judgment is made of the extent to which each subsidiary is, in practice,

Exhibit 1
Typical Holding Company Financial Leverage & Interest Coverage Guidelines

ICR Category	Debt/Capital*	Interest Coverage**
aaa	<15%	>10x
aa	<25	>7x
a	<35	>5x
bbb	<45	>3x
bb	<65	>2x
b	>65	<2x

* Long-term + Short-term Debt (adjusted for hybrid securities) / [(Total Shareholder's Equity + Minority Interest and Other + Preferred Stock (Non Equity) + Long-term Debt + Short-term Debt) net of AOCI]
** Pretax Operating Income + Interest Expense / Interest Expense + Preferred Dividends
A.M. Best's economic view of capital in any given organization can differ significantly from reported capitalization.

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SR-2012-M-395a

supporting the borrowing and, as a result, the levels of leverage relevant to each subsidiary's Best's Credit Rating.

In addition to leverage, A.M. Best considers the quality of the capital structure and the permanency of capital. As part of its quality-of-capital analysis, A.M. Best reviews the terms and conditions of securities issued, the maturity schedule of the capital structure, and the level of goodwill, value in force, deferred acquisition costs and other intangible assets relative to reported equity and total capitalization. The level of intangible assets is of particular importance when such items constitute a significant portion of an organization's capital base, thereby distorting financial leverage ratios relative to its peers.

Coverage Ratios

In evaluating an IHC's ability to service its financial obligations, A.M. Best considers several coverage ratios, including interest and fixed-charge coverage. In evaluating coverage levels, A.M. Best factors the current and expected interest rate environment into consideration of the strength of coverage.

The ability to service financial obligations over time is a function of the organization's current capitalization and ability to generate earnings from operations. Unencumbered cash, cash equivalents and short-term investments held at the IHC also may support the parent company's debt service and other short-term obligations. Management's track record of share repurchases and shareholder dividends is considered as part of the assessment of the IHC's prospective creditworthiness and expected coverage ratios.

Operating Leverage

To supplement its assessment of financial leverage, A.M. Best also reviews a company's operating leverage. A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on an insurer's earnings and cash flow. Generally, debt obligations viewed by A.M. Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

Liquidity

An IHC's liquidity depends upon the degree to which it can satisfy its financial obligations through operating cash flow or by holding cash and investments that are sound, diversified and liquid. The source of cash flow available to an IHC with few operations relies primarily on the dividend-paying capacity of its subsidiaries. Dividend capacity, in turn, depends in part on the organizational structure, recognizing that a generally flat structure is preferable to a stacked structure. The presence of profitable, nonregulated subsidiaries is viewed positively, as there are no limitations on the amount of dividends that may be sent upstream. Additional sources of cash, including bank credit facilities, also can enhance a holding company's liquidity. A high degree of liquidity enables an insurer to meet unexpected needs for cash without the untimely sale of investments or fixed assets, which may result in substantial realized losses due to temporary market conditions and/or tax consequences.

Asset Allocation/Investment Risk

The quality and diversification of assets contribute to a company's financial stability. Invested assets (principally bonds, common stocks, mortgages and real estate) are evaluated to assess the risk of default and the potential impact on capital and surplus if the decline in market value of these assets occurred unexpectedly. The higher the liquidity, diversification and/or quality of the asset portfolio, the less uncertainty there is in the value to be realized upon an asset sale and the lesser the likelihood of default. Therefore, a company's investment guidelines are reviewed to identify a lack of diversification among industries or geographic regions, with particular attention paid to large, single investments that exceed 10% of a company's total capital. Companies that hold illiquid, undiversified and/or speculative assets, and that have significant underwriting exposure to volatile lines of business that are vulnerable to unfavorable changes in underwriting and/or economic conditions, can jeopardize capital and surplus.

Off-Balance-Sheet Risk

If an IHC is exposed to off-balance-sheet items, including balances associated with noncontrolled assets, guarantees for affiliates, contingent liabilities, unfunded pension plan obligations, long-term lease obligations and interest-rate swaps, the off-balance-sheet items are analyzed to determine the potential effect on the group's financial flexibility, liquidity, surplus or loss exposure.

Capital Adequacy

As part of its analysis of the organization's financial strength as a whole, A.M. Best may use a consolidated Best's Capital Adequacy Ratio (BCAR) to evaluate the risk-adjusted capitalization using the consolidated financial statements of the IHC or the operating insurance parent company if no IHC exists.

A consolidated BCAR is calculated based on the ratio of the organization's available capital relative to net required capital.

$$\text{Consolidated BCAR} = \frac{\text{Available Capital}}{\text{Net Required Capital}}$$

Available capital represents the capital available to the entire organization to absorb adverse deviations in its investment, credit, underwriting and off-balance-sheet risks.

A.M. Best's capital formula uses a risk-based capital approach whereby net required capital is calculated to support three broad risk categories: investment risk, credit risk and underwriting risk. A.M. Best's capital adequacy formula also contains an adjustment for covariance, reflecting the assumed statistical independence of the individual components. A company's available capital is divided by its net required capital, after the covariance adjustment, to determine its BCAR.

A.M. Best makes a number of adjustments to a company's reported capital within its capital model to provide a more economic and comparable basis for evaluating capital adequacy. After gaining an understanding of the inherent risk relating to off-balance-sheet items, the analyst will make qualitative assessments of off-balance-sheet liabilities that might encumber a company's growth or preservation of surplus and may modify the capital charge in a consolidated BCAR to reflect the appropriate level of risk.

Different accounting frameworks and regulatory requirements across the world require numerous adjustments to a company's reported capital. Goodwill and other intangible assets are adjusted. Pre-event catastrophe reserves are removed from the loss reserves and moved into available capital on a tax-effected basis. Adjustments for any embedded value in unearned premium reserves, loss reserves and fixed-income securities are made if the company has not already reflected these in its reported capital. Further adjustments are made to capital to reflect other non-balance-sheet risks, including catastrophe exposures and debt-service requirements.

The BCAR model produces an absolute score, which is the ratio of the company's adjusted capital to its own net required capital. This capital ratio is based on the specific risk profile of a company's operations.

Enterprise Risk Management

A.M. Best believes that enterprise risk management (ERM) – establishing a risk-aware culture, using sophisticated tools to consistently identify, manage and measure risk and risk correlations – is an important component of an insurer's risk management framework. This includes t an ongoing effort to refine an ERM framework, including the development of internal economic capital modeling at the consolidated or group level. When analyzing an IHC, A.M. Best will assess an organization's risk management practices relative to the risk profile of the company based on volatility of earnings and capital over time.

Exhibit 2
Available Capital Components

Reported Capital

Equity Adjustments:
- Unearned Premiums
- Assets
- Loss Reserves
- Reinsurance

Debt Adjustments:
- Debt/Hybrid Securities
- Debt-Service Requirements

Other Adjustments:
- Potential Catastrophe Losses (net of reinsurance)
- Future Operating Losses
- Future Dividends
- Contingent Capital
- Contingent Reserves
- Value in Force (life business)
- Deferred Acquisition Costs
- Goodwill
- Other Intangible Assets

Non-Rated Affiliates

Another important part of A.M. Best's top-down rating approach is the review and analysis of non-rated affiliates. This typically will be incorporated into the assessment of the ultimate parent's activities through the analysis of information – such as the organizational chart and consolidated financials – with company management. A.M. Best reviews the group for the potential benefit or drag any affiliate can represent. To gain comfort with a group's non-insurance affiliates, A.M. Best's analysts hold discussions with management to determine these entities' strategic fit. Additionally, A.M. Best's analysts may use public information, third-party analytical studies and industry reports, as well as their own analysis of management-provided information, to assess a non-insurance affiliate's financial condition.

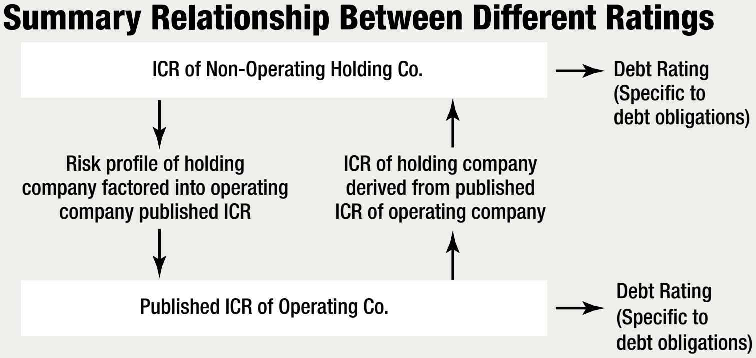
Double Leverage

Another measure used to assess capitalization is double leverage, or the ratio of a holding company's investments in subsidiaries to its adjusted equity. Double leverage is used to determine the extent to which debt issued at the holding company is contributed as equity to one or more operating companies. High double leverage not offset by mitigating factors can lead to an unfavorable view of an organization's capital structure and/or the quality of capital at the operating company.

Rating the IHC

The rating of the IHC is determined by reference to the ICR of the operating insurer and reflects analysis of both the credit risk implications of the IHC being a separate legal entity from the operating insurer, and the normal subordination of IHC creditors to operating company policyholders (see **Exhibit 3**).

Exhibit 3
Summary Relationship Between Different Ratings



Since an IHC typically does not generate significant earnings independent from subsidiary operations, its legal separation from the operating company represents an added degree of risk, especially in terms of the actual or potential control a regulator may apply to the movement of funds from an operating insurer to an IHC. Moreover, the policyholders of the operating insurer usually have seniority over creditors of the IHC.

Due in part to the greater degree of risk taken by senior unsecured creditors of the IHC relative to that of the operating company, the IHC normally is assigned a lower ICR than the operating company (see **Exhibit 4**). Maximum dividend levels or other constraints on the movement of funds from the operating company to the IHC also are reflected in the notching between operating and IHC ICRs.

Exhibit 4
ICR to ICR Typical Notching

Operating Co.	Holding Co.
aaa	0-2
aa+	2-3
aa/aa-	3
a+/a/a-	3
bbb+/bbb	3
bbb-	3-4
bb+/bb	4
bb-	4-5

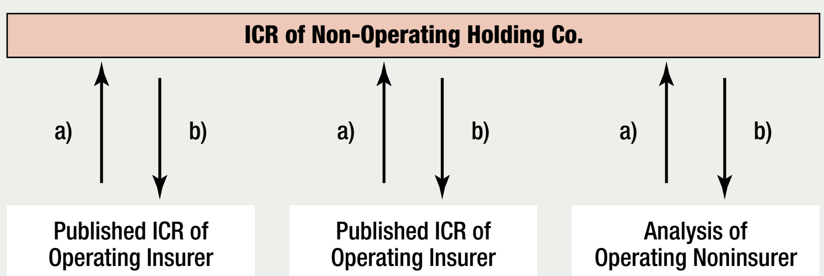
For highly rated operating insurers, IHC ICRs usually are two or three notches lower. Farther down the rating scale, this may extend to four or five notches. Conversely, for the very strongest organizations, with diversified operations, this notching could be reduced to zero (i.e., if after taking into account the risks highlighted above, the credit profile of the IHC still was consistent with a rating of “aaa”).

For more complex organizations, with multiple insurance or non-insurance operations owned by an IHC, the same analytical logic is applied. Additional judgment is used as to which operating subsidiaries the IHC primarily depends upon to meet its obligations and, hence, which operating company ICRs are most relevant to the notching process (see **Exhibit 5**).

Exhibit 5
Summary of Relationship Between Different Ratings for Complex Organizations

a) The ICR of the holding company is derived from the published ICRs of the operating companies via A.M. Best’s analysis of the degree of impact each operating company has on the holding company's creditworthiness and any benefits it gains from diversified sources of funds from operations.

b) The published ICRs of the operating companies reflect A.M. Best’s analysis of the extent to which each is supporting debt, or other obligations, of the holding company or of affiliated companies.



An IHC may provide rating enhancement to an operating company. If an IHC maintains significant liquid assets, these will be factored into the operating company’s published ICR, if it is considered these funds would be available to meet its ongoing insurance obligations. If these funds are not considered available to meet policy and contract obligations but appear to be a sustainable feature of the IHC’s balance sheet, the liquidity at the IHC may be factored into the degree of notching between the IHC and the operating company ICR.

Similarly, if an IHC maintains weak leverage or coverage measures relative to the operating company’s ICR, then this will be factored into the operating company’s published ICR. In both cases, the ICR of the IHC is notched from the published ICR of the operating company.

Debt & Preferred Stock Ratings
If an insurance organization issues public debt, A.M. Best may assign a rating specific to its view of the credit quality of the debt issue. The debt rating is established by reference to the ICR of the issuing entity, whether it is an operating holding company or an IHC.

As a guideline, ratings of debt issued by an IHC are notched from the IHC ICR. A.M. Best views the subordination of the security in the capital structure of the IHC as the primary factor for notching. The rationale is that in the event the IHC becomes bankrupt, senior obligations theoretically must be repaid before subordinated creditors receive any payment. The contractual subordination in the capital structure is emphasized rather than the name of the security. As a guideline, securities described in the indenture agreement as being senior to all other unsecured obligations receive 0 notches from the ICR of the IHC. Securities contractually subordinated only to senior debt receive 1 notch. Securities contractually subordinated to senior debt and subordinated debt receive 2 notches. Additionally, aggressive loss-absorption features can influence notching. Features such as contingent write-downs or conversions to equity can result in wider notching if in a stressed scenario the debt would convert to a more subordinated type of security. On the other hand, features that do not affect subordination (e.g. interest deferral) do not have an effect on notching. If a company with an existing issue of subordinated debt issues additional subordinated debt ranked senior to the existing issue, then the rating of the prior issue may be downgraded. This approach is consistent with a rating assignment based primarily on structural subordination.

Exhibit 6
Notching

Security Type	Notches From Non-Operating Holding Company
Senior Debt	0
Subordinated Debt	-1
Junior Subordinated Debt, Trust Preferred, Capital Trust Securities, Preferred Securities/Stock	-2

Generally, only three levels of notching (0, 1, or 2) are assigned to securities in an IHC, irrespective of the number of securities in the capital structure. A.M. Best's view is that in a bankruptcy scenario for an IHC, the recovery differences among securities with 2 or more notches are not likely to be significant. As such, it is possible for instruments with different subordination to have the same level of notching (see **Exhibit 6**).

Although preferred and trust-preferred securities are viewed as having creditworthiness less than that of junior subordinated debt, each security is generally rated two notches below the IHC's ICR. In cases where a trust or special-purpose entity issues securities backed by a different class of securities, the securities issued by the trust are notched one below the securities issued by the insurance entity to fund the obligation, subject to the cap on notching. For example, if A.M. Best rates trust-preferred issues that are backed by subordinated debt, the instrument is rated at the same level as the trust-preferred securities, given that the trust-preferred securities are further removed from the cash flows of the operating company. Modifications to this can occur, depending on the details of the issue. If debt subordinated to senior debt were to be issued, and no senior debt exists, then the debt would be notched 1 from the holding company, effectively allowing a placeholder in the event senior debt were issued.

Exhibit 7
Typical Notching from Operating Company ICR to Operating Company Debt Instrument

Issuer Credit Rating	Senior Unsecured Debt	Subordinated Debt	Preferred Stock*
aaa/aa/a	1	2	3
bbb+/bbb	1	2	3
bbb-	2	3	4
bb+ or below	3 or more	4 or more	5 or more

* This also applies to junior subordinated debt, trust preferred and capital trust securities.

Ratings of debt issued by operating companies are notched from the published ICR of the operating company. For debt issued by operating companies, the degree of contractual subordination of the rated issue to the most senior creditors (usually policyholders) is reflected in the rating level. For higher rated insurers, senior unsecured debt most frequently would be one rating notch below the ICR (reflecting debt-holder subordination to policyholders), subordinated debt two notches, and so forth. However, for issuers at the lower rating levels, notching between policyholder and senior debt-holder obligations may be expanded as the ICR moves farther down the rating scale. The increase in notching at the lower ICR levels reflects the generally increased probability for regulatory intervention (see **Exhibit 7**).

In certain jurisdictions, the seniority of policyholders and senior debt holders are *pari passu*. In that scenario, senior debt would receive 0 notches instead of 1, subordinated debt would receive 1 notch instead of 2, and preferred stock would receive 2 notches instead of 3.

Equity Credit for Hybrids

The issuance of nontraditional debt securities by either an IHC or an insurance operating company may receive favorable treatment of hybrid securities relative to traditional debt instruments due to the existence of equity-like features or characteristics. A.M. Best's assessment of these securities, and the resulting impact on financial leverage and coverage ratios, focuses on the use of the instruments within an entity's capital structure and the impact on financial ratios and financial flexibility.

In ranking equity-credit-afforded securities along the continuum, A.M. Best places straight debt and securities with a cash put option at one end and common stock at the other end. All other securities fall between, based on loss-absorption characteristics and cash-flow flexibility. In general, the longer the maturity, the longer interest/dividend payments may be deferred, and the deeper the subordination, the higher the equity credit given to a hybrid security. However, these instruments can be extremely complex and require extensive rating analysis. As such, determination of equity credit for hybrid securities will be made on a case-by-case basis. Generally, A.M. Best grants equity credit, comprising up to 20% of a company's total capital, for hybrid securities that exhibit the characteristics of common equity. The amount of credit given to hybrid securities is based on A.M. Best's belief that the insurance industry, as well as the broader financial services sector, is very sensitive to changes in the market's perception of an issuer's financial health.

Transfer & Convertibility Ceilings

IHC ratings are subject to transfer and convertibility (T&C) ceilings. A.M. Best defines transfer and convertibility risk as the risk that capital and exchange controls may be imposed by government authorities that would prevent or materially impede the private sector's ability to convert local currency into foreign currency and/or transfer funds to nonresident creditors. A.M. Best employs a two-step process to calculate the T&C ceiling. The process starts with a sovereign rating and then estimates the likelihood of a government implementing currency restrictions given default. Thus T&C ceilings are always equal to or higher than a country's sovereign rating.

Factoring In Government Support

Government support, either through explicit forms (e.g., written guarantee) or via implicit (noncontractual) support, can increase the published ICR of the IHC. Explicit financial support demonstrates the government's commitment to an organization. Such support comes in the form of a capital contribution or a contractual arrangement that exhibits the commitment. The level of benefit afforded to an IHC's rating depends on the type of explicit financial support provided. Guarantees that offer full protection can provide rating enhancement.

An IHC also may receive rating enhancement based primarily on the level of implicit support expected from the government. However, the amount of explicit support already provided to the IHC also influences the level of implicit support A.M. Best anticipates and the level of benefit in a rating. These judgments are subjective and are decided by a rating committee following a formal rating analysis, which includes the evaluation of information gathered through detailed discussions with government officials/management to gain a complete understanding of the government's relationship to the organization.

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

METHODOLOGY

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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.

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Version 020116