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## Analyzing Insurance Holding Company Liquidity

An analysis of insurance holding company liquidity is an integral part of understanding potential stresses on an insurance operating company, because the key source of holding company liquidity is generally the dividends received from owned insurance operating companies.

A.M. Best analysts will review current and projected sources and uses of cash for the holding company. An assessment will be made on the sustainability of the current sources of funds and access to any alternative funding. In addition, the analysts will review the certainty of cash uses such as fixed charges and maturing debt. Holding companies with well-laddered liability profiles will be viewed more favorably than those with large concentrations of maturities that place additional stress on sources of liquidity.

Holding companies possessing a good liquidity profile generally are viewed more favorably by A.M. Best analysts because of perceived improved financial flexibility. Diverse sources of funds, including the maintenance of assets identified as cash equivalents, will assist holding companies in meeting their operating needs, funding subsidiaries to support growth initiatives, meeting short-term debt obligations of both principal and interest expense, and potentially returning cash to shareholders in the form of cash dividends and/or share repurchases. However, A.M. Best analysts will analyze both the various sources and demonstrated sustainability of liquidity, in addition to just measuring the current absolute level of liquidity a holding company maintains.

A.M. Best's analysis of overall holding company liquidity risk incorporates all of its near-term claims on cash, both direct and contingent. A detailed, quantitative and qualitative review of sources and uses of liquidity, market conditions and contingency plans is necessary, since the ability to generate immediate and near-term cash flow can vary significantly among holding companies.

Properly understanding relevant issues, such as the short-term funding risk and debt-service requirements of a holding company, requires an in-depth dialogue between A.M. Best's analytical team and senior management of the holding company. This analysis generally focuses on the typical sources and uses observed at the holding company level.

In addition, each organization generally will have its own unique profile around maintaining liquidity. One enterprise may keep a specified target amount of liquidity at the holding company level, for example two times annual fixed-charge coverage. At the other end of the spectrum, another enterprise may elect to keep most of the liquidity at the operating company level and only require dividends to be sent up to the holding company "as needed." Still other holding companies may have alternative liquidity sources where dividends are divided between subsidiaries with, and without, restrictions on dividends paid to the holding company. The analyst needs to understand, on a case-by-case basis, what are a holding company's projected sources and uses over the next 12-18 months to help assess overall strength or weakness of liquidity.

**Note:** Most of this criteria report focuses on non-operating holding companies. To the extent the holding company is also an operating company, the analyst needs to account for the additional sources and uses that may be due to a company's operating activities, including invested assets and policyholder liabilities.

### Additional Information Criteria:

Evaluating Non-Insurance Ultimate Parents

Insurance Holding Company and Debt Ratings

A.M. Best's Perspective on Operating Leverage

Understanding Universal BCAR

Understanding BCAR for U.S. Property/Casualty Insurers

Understanding BCAR for U.S. and Canadian Life/Health Insurers

Equity Credit for Hybrid Securities

A.M. Best's Stress Liquidity Ratio for U.S. Life Insurers

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Utilizing *Best's Credit Rating Methodology*, the analyst generally assigns a holding company issuer credit rating that reflects the company's ability to meet its financial obligations. This rating generally reflects notching off of the rating of the operating companies. The holding company's rating is important because it often dictates the company's ability and cost to access the capital markets. This criteria supports that approach with an overall qualitative assessment of a company's liquidity position.

Most holding companies first rely on their own internal funding sources, which include cash and securities maintained at the holding company level. This generally is supported by dividends received from owning operating subsidiaries. However, by virtue of being regulated, there are usually restrictions on insurance operating company dividends paid to the parent holding company. Each jurisdiction has its own restrictions for regulated insurance operating companies with respect to availability of dividends. For example, in the United States, the most typical requirement is to limit the annual dividend to either the "greater of" or "lesser of" 10% of total surplus, or the amount of statutory operating earnings in the prior calendar year, without additional state approval. Therefore, A.M. Best analysts need to be aware of the specific state requirements for each regulated operating subsidiary that could dividend funds to the holding company.

To avoid scenarios where holding companies became over-reliant on commercial paper and cannot meet short-term obligations if the market freezes. A.M. Best believes holding companies are in an overall better credit position by maintaining cash buffers and thereby reducing potential future dividend calls from insurance operating companies if adverse situations arise.

### Analysis of Sources and Uses

Holding companies generally issue both short- and long-term financing instruments. In evaluating a holding company's liquidity risk, the holding company's potential near-term obligations are considered and compared with all likely near-term sources of cash. The analysis of an issuer's short-term creditworthiness begins with a careful assessment of its liability structure, including an array of maturing obligations over the short term; the maturity profile/liquidity of any invested assets held at the issuer level; and the exposure of the assets and liabilities to market risk. The purpose of the assessment is to determine the magnitude of short-term funding and any maturing long-term funding utilized in the capital structure, in addition to any other potential short-term obligations that the company's alternative liquidity arrangements may be required to fund. Outstanding commercial paper is a component of near-term obligations, while bank credit facilities often are viewed as a component of the potential near-term sources of cash until drawn.

Sources and uses also change over time. In times of financial crisis, many funding sources can dry up and become unavailable even for highly rated entities. On the other hand, a company's maturing debt may not be properly laddered, thereby presenting a sizable refinancing risk in the near term when the ability to refinance may not be available, whether for company-specific or general capital market reasons. A company's liquidity policy should not only address known uses but represent a strategy for handling stress scenarios. Liquidity is the first line of defense against adverse pressures from either internal or external forces.

A.M. Best's analysis includes a critical evaluation of an issuer's sources and uses of cash. To assess the company's ability to meet both operating needs and debt obligations, a variety of plausible stress scenarios are analyzed. Next, contingency funding plans for a sustained period of stress, caused by either company-specific concerns or capital or general market disruptions, are

examined. In the case of an operating company issuer, general disruptions could be event driven, such as large catastrophic claims following an earthquake or hurricane; a “run on the bank” following a credit event; or declines in investment portfolio valuations due to volatile securities markets. Capital market disruptions usually are related to broader, systemic dislocations such as a financial crisis, when an issuer’s ability to roll commercial paper or refinance maturing debt is nonexistent. Tightening or absolute capital market seizures can lead to a contagion effect, which can create difficulties for all issuers. During times of systemic financial stress in which market downturns can exceed the most severe downside projections, A.M. Best anticipates that virtually all commercial paper programs, although backed by committed bank lines of credit or other, alternative sources of liquidity, will be shut down with no new issuance.

Access to alternative liquidity usually occurs with larger, highly rated issuers that have considerable financial flexibility. In these cases, analytical principles that are emphasized include the matching of cash flows for short-term assets and liabilities; the quality of assets with intrinsically high cash flows; and the availability of financial and other assets that can be monetized quickly at close to par.

A.M. Best notes that property and casualty risk characteristics are largely uncorrelated with market risk, as short-term concerns over liquidity likely would be triggered by a catastrophic loss event. Property/casualty insurers generally make more use of contingent financing arrangements to protect against such event-driven stresses. Life insurance companies, particularly annuity writers, have a higher correlation with market movements, as their products carry equity and interest rate risks. In either case, the ability to readily access alternative sources of short-term funding is crucial in determining a holding company’s liquidity position.

### Liquidity Analysis

The purpose of the analysis is for A.M. Best to become comfortable that the holding company can smoothly gain access to funds to meet known obligations, with an additional buffer to cover potential unknown situations, and limit the reliance on insurance operating company dividends.

Therefore, a thorough understanding of each issuer’s liquidity profile should be considered in the context of immediacy, quality and diversity. The following depicts, at a high level, the elements of A.M. Best’s liquidity analysis:

- Discuss topics such as management’s philosophy with regard to liquidity and financial flexibility and how short-term borrowings fit into an insurer’s overall funding strategies.
- Determine the minimum required cash position (with buffer) to meet short-term liabilities.
- Evaluate operating cash flow, including premiums from in-force business and the degree of volatility of operations.
- Determine all short-term sources of financing available to the issuer (including the availability of subsidiary dividends) and review all short-term funding arrangements such as commercial paper programs.
- Evaluate the degree of dependence on the various sources of liquidity.
- Consider the loyalty and financial strength of banking relationships and other backup arrangements.
- Calculate the company’s current and prospective interest coverage and cash coverage ratios to evaluate earnings coverage.
- Determine overall financial leverage and the ability to repay current liabilities.
- Determine the company’s dependence on operating leverage and the ability to liquidate assets to repay “matched” obligations.
- Discuss stress scenarios and contingency plans should commercial paper and similar funding suddenly become unavailable.

## Sources of Liquidity

Insurance holding companies have internal and external sources of liquidity. In general, the most reliable source of liquidity is from internally generated sources of funding. This includes the following:

### *Internal Sources of Liquidity*

#### Cash on Hand

In evaluating an insurance holding company's cash on hand, A.M. Best may consider:

- Possible restriction due to minimum bank balance requirements.
- Possible complications related to cross-border repatriation, currency conversion, tax issues, regulatory concerns and sovereign risks.

### *Near-Term Cash Resources*

In evaluating an insurance holding company's near-term cash resources, A.M. Best considers:

- Liquidity of any investments held at the holding company by investment type. Under potential stress market conditions, A.M. Best will assess a potential range of market values and potential timing of conversion to cash for any investments held at the holding company.
- Operating cash flow.
- Dividend capacity of subsidiaries (including non-insurance or non-regulated entities). Some insurers have placed invested assets into non-regulated subsidiaries that do not have dividend restrictions, enabling an unrestricted source of interest income that is viewed more favorably in terms of liquidity.
- Alternative value scenarios for liquidity in a stress situation (i.e., mark-to-market).
- Strength, diversity and availability of cash flows, with higher emphasis placed on unregulated, near-term cash flows.
- Assets that may already be pledged or posted as collateral (i.e., under a derivative agreement [ISDA] with a Credit Support Annex) may be returned or freed up based on market moves.

### *External Sources of Liquidity*

#### Commercial Paper

Commercial paper is defined as a short-term, negotiable, unsecured promissory note, generally issued to meet a corporation's current cash liquidity needs. It often is seen as a prudent source of funding when matched with a corporation's operating needs, providing a diversified and cost-effective source of funding compared with bank loans.

Although large, highly rated issuers can access the commercial paper market directly, commercial paper often is issued through dealers that specialize in buying commercial paper from issuers and then selling it to investors. The dealer market primarily consists of large securities firms, often affiliated with bank holding companies. There is no real secondary market for commercial paper, but dealers generally will make a market in paper that they have helped issue.

For example, in the United States, most commercial paper is exempt from registration with the Securities and Exchange Commission (SEC), as its maturity rarely exceeds 270 days. The majority of commercial paper has a maturity of 30 days or less. Commercial paper is considered a money market security and generally is issued on a discount basis (actual/360). Insurers generally issue commercial paper to finance premiums and cover other operating expenses.

The two main risks with commercial paper are the credit risk of the issuing entity and rollover risk, or the inability of the issuer to fund maturing commercial paper with ongoing issuances. Commercial paper generally is considered a low-risk security for the investor, as it typically is issued only by highly rated entities for short maturities. A lesser risk is interest rate risk, although this is minimized by the short maturity profile of the paper.

**A.M. Best’s Commercial Paper Rating Scale**

The evaluation of an issuer’s commercial paper reflects A.M. Best’s opinion of the issuer’s overall credit quality. As a result, the analytical approach is very similar to that of assigning a long-term rating. However, the long-term rating will not fully determine a commercial paper rating because of the overlap in rating categories. In these cases, further testing of liquidity and cash flows, together with other short-term credit-quality metrics, is necessary. **Exhibit 1** shows the linkage between a short-term and a long-term rating.

**AMB-1+ (Strongest)**

Issuers rated AMB-1+ have, in A.M. Best’s opinion, the strongest ability to repay their short-term financial obligations.

Characteristics of this rating category include exceptional capital management, as well as significant liquidity and financial flexibility. Management’s strategy ensures strong earnings and sustainable operating trends. Financial management is conservative, with low debt-to-capital and excellent fixed-charge coverage ratios. Significant liquidity is available internally from a diverse earnings base, as well as from excess cash available on the company’s balance sheet. External sources of liquidity include committed bank lines of credit and access to cash through the capital markets.

**AMB-1 (Outstanding)**

Issuers rated AMB-1 have, in A.M. Best’s opinion, an outstanding ability to repay their short-term financial obligations.

Most credit characteristics discussed in AMB-1+ will be similar for AMB-1, with slightly lesser strengths. Issuers in this rating category will have a strong capability to service short-term debt. Fixed-charge coverage, liquidity and capital structure also are favorable. The issuer displays ready access to the capital markets and has significant alternative liquidity available to repay short-term financial obligations.

**AMB-2 (Satisfactory)**

Issuers rated AMB-2 have, in A.M. Best’s opinion, a satisfactory ability to repay their short-term financial obligations.

While alternative liquidity remains adequate, companies in this category have more variability in earnings, cash flow and fixed-charge coverage. Companies at this rating level may not be able to rely consistently on the capital markets to fulfill liquidity needs. However, they maintain adequate alternative liquidity protection.

**Exhibit 1  
Short-Term Rating Matrix**

Long-Term Issuer Credit Rating	Short-Term Issuer Credit Rating			
aaa	AMB-1+			
aa+				
aa				
aa-				
a+				
a		AMB-1		
a-			AMB-2	
bbb+				AMB-3
bbb				
bbb-				
bb+				AMB-4
bb				
bb-				
b+				
b				
b-				
ccc+				
ccc				
ccc-				
cc				
c				

***AMB-3 (Adequate)***

Issuers rated AMB-3 have, in A.M. Best's opinion, an adequate ability to repay their short-term financial obligations; however, adverse industry or economic conditions likely will reduce the issuer's capacity to meet its financial commitments.

***AMB-4 (Questionable)***

Issuers rated AMB-4 have, in A.M. Best's opinion, questionable credit quality and are vulnerable to adverse economic or other external changes, which could have a marked impact on their ability to meet their financial commitments.

**U.S. Commercial Paper Programs**

As stated above, in general, all U.S. commercial paper programs are exempt from SEC registration as long as the final maturity is less than 270 days. Below are three types of programs, of which the first is most widely used by insurers.

**3(a)(3)**

- Maturities limited to 270 days.
- Proceeds must be utilized for current transactions.

**4(2)/144A**

- Does not limit maturities, but generally less than one year.
- There is no limit on the use of proceeds.
- Exemption based on the private placement nature of this note offering.

**3(a)(2)**

- This exemption is available for bank obligations, both direct and via a letter of credit (LOC).
- LOC-backed commercial paper that is issued by a corporation or institution and "guaranteed" by a commercial bank.
- LOC programs carry the credit rating of the LOC bank.
- The obligation of the LOC bank is irrevocable and unconditional, regardless of the issuer's financial condition.

**Bank Credit Facilities**

In assessing an insurance holding company's bank credit facilities, A.M. Best considers both quantity and quality. Uncommitted credit facilities, bilateral (one-off) lines of credit or facilities syndicated with very few banks may be more risky when the banking system is stressed. High levels of participation in a syndicated credit facility could lead to majority control by a few banks. This could work against a company in stressful situations when amendments or waivers are required to avoid default. However, in practical terms it may be easier to negotiate an amendment/waiver with fewer lenders than with more. The analysis also considers the financial strength of each lender and relationship factors.

Borrowing options should include same-day funding, as adverse markets may cause the company to suddenly need same-day funds to roll over maturing commercial paper. Alternative liquidity is examined to ensure that swing lines - portions of a credit facility that can be accessed on very short notice - are available for immediate coverage on commercial paper issued. A.M. Best seeks to become comfortable that the company has sufficient immediate liquidity to repay all commercial paper that comes due on any given day.

Documentation of credit facilities (usually the term sheet) is reviewed carefully to determine how much flexibility a company is allowed within the provisions. These include:

- Covenants
- Material adverse change (MAC) clauses (including rating triggers)
- Events of default
- Cross-default and cross-acceleration provisions
- Maturity date
- Conditions of funding
- Changes in control or management
- Renewal procedures for multiyear or 364-day revolving credits

Due consideration is given to contractually committed bank lines compared with an uncommitted credit facility such as advised and/or guidance facilities, which the lender can withdraw at will. A.M. Best also places greater value on relationship-based, committed bank facilities than on transactional or arms-length arrangements, and factors the remaining duration into its assessment.

A.M. Best can request a copy of the credit agreement to assess this alternative source of holding company liquidity. For example, often a portion of a credit facility will be allocated to backstop commercial paper borrowings. Additionally, insurers will use a portion of a facility to issue irrevocable Standby Letters of Credit. Both of these uses will reduce the overall borrowing capacity for the holding company.

### Letters of Credit (LOCs)

While the practice is not prevalent among insurance holding companies, occasionally they may enhance their liquidity by issuing commercial paper backed by a LOC from a bank. To provide true liquidity, the LOC has to be an irrevocable and unconditional guarantee that will pay off all commercial paper at maturity in all cases. However, while the LOC provides current liquidity to the company, the bank – not the issuer – bears credit risk. In such cases, A.M. Best may rate the commercial paper program higher than the stand-alone debt rating because of the credit enhancement from a bank of stronger credit quality.

Insurance holding companies that own a Lloyd's corporate member are able to use letters of credit to support their underwriting at Lloyd's, and more recently, insurance holding companies have been obtaining letters of credit to fund captive operating companies or even issuing guarantees counted as assets in certain jurisdictions. Although not directly linked to liquidity, they are potential significant uses of cash that should be addressed in any liquidity analysis.

### Federal Home Loan Bank Borrowings

In the United States, many insurance operating companies have joined their local Federal Home Loan Bank (FHLB) networks through investment in capital shares. In turn, the FHLB will allow the insurer to leverage this investment through the advancement of funds. This alternative access to liquidity generally provides insurance companies with a diversified source of funding, stopgap liquidity, support for match-funding programs and the ability to enhance yields through more robust liquidity management. A.M. Best generally views borrowed funds used for institutional match-funding programs as operating leverage. Alternative uses are more likely than not to be treated as financial leverage. From a liquidity standpoint, analysts should ensure that if a holding company is borrowing directly from an FHLB, assets are properly matched to the tenor of the borrowing and the quality remains investment grade.

### Uses of Liquidity

The general uses of liquidity for an insurance holding company are retiring direct obligations such as short-term borrowings or maturing long-term borrowings. In addition, liquidity generally is necessary

to fund working capital needs such as covering operating expenses, debt service requirements or funding growth at the subsidiary level. Finally, outside investors generally are looking for a return on their investment either from common or preferred stock dividends and/or share repurchases.

### Evaluating Cash Outflows

The analyst first considers the cash sources available to meet obligations. Then the analyst lists forthcoming claims on cash, including operating uses of cash; the maturity profile for servicing debt and other financial claims; claims that could become payable at the option of the creditor; and reasonably possible contingencies. A.M. Best also will factor in management's track record of reducing discretionary cash outflows in periods of increasing financial stress.

**Note:** Most use of securities lending and/or repurchase agreements is undertaken at the operating level and therefore is not usually done at the holding company. However, these activities could be direct obligations of the holding company, and any funding issues at the subsidiary level on these activities may eventually be a call on cash from the holding company. Additionally, if the insurance holding company itself is under an ultimate parent, any additional cash sources or uses due to this relationship may be reviewed and included in the analysis.

### *Potential Near-Term Claims on Cash*

#### Direct Obligations

- Fixed-charge servicing (including interest expense and preferred dividends)
- Short-term debt
- Current portion of long-term debt
- Contingent obligations
- Funding arrangements (including the use of reverse repos)
- Financial and commodity derivatives contracts (including the posting of additional collateral)
- Off-balance-sheet financing obligations
- Potential litigation settlements or judgments
- Margin requirements

#### Other Claims on Cash

- Operating expenses
- Capital spending commitments or investment commitments
- Common stock buybacks
- Common stock dividends
- Guarantees made by the holding company (i.e., more recently many holding companies have received a permitted practice in certain states to capitalize their captive insurance companies through the use of a parental guarantee)
- Funding shortfalls from subsidiary operations (i.e., collateral calls for obligations originating at the subsidiary level such as derivative counterparty exposure or liabilities from settling securities lending or repurchase obligations)
- Funding of potential lawsuits, which are often difficult for the company to quantify



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## 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.

**Best's Issue 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.

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