BEST'S METHODOLOGY AND CRITERIA

Evaluating U.S. Surplus Notes

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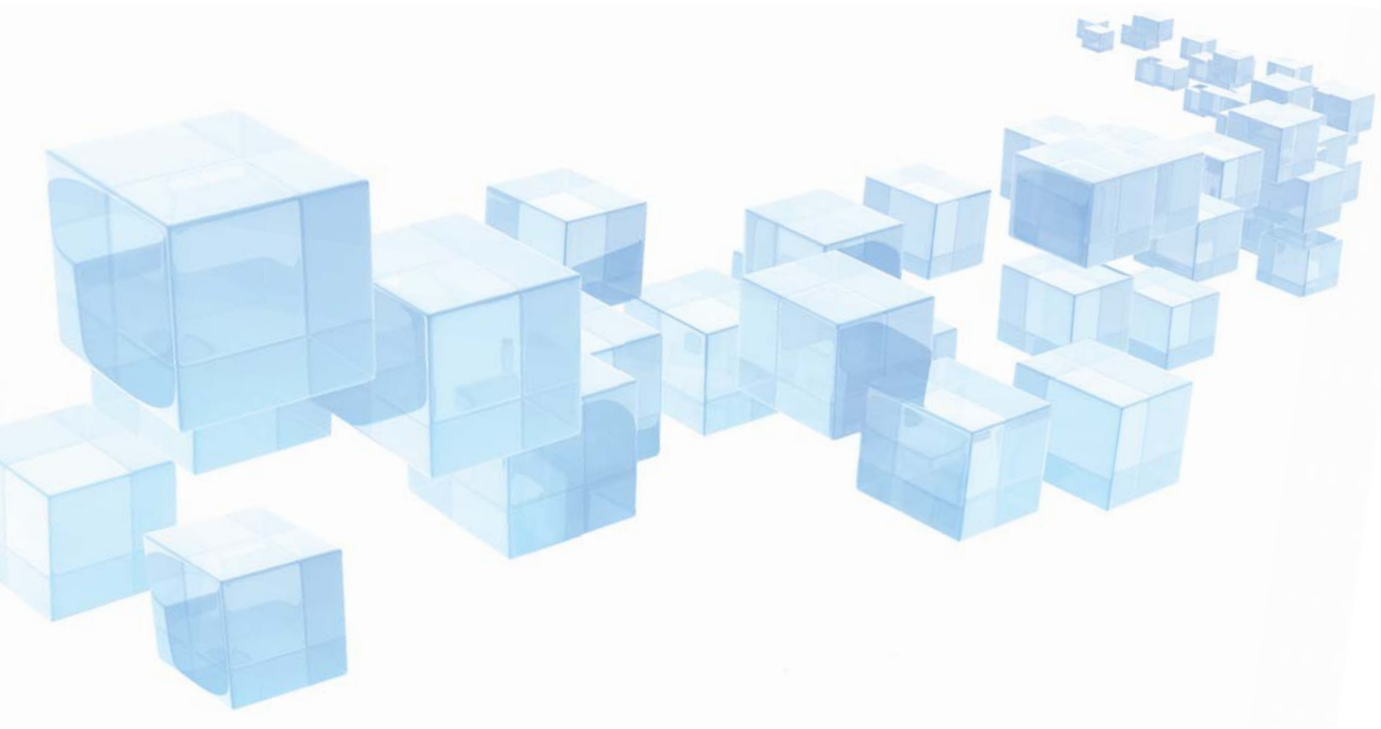

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Outline

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of A.M. Best Rating Services' rating process.

A. Market Overview

Surplus notes, also referred to as surplus debentures, contributed certificates, or capital notes, are unsecured indentures that may be issued directly by insurance operating companies domiciled in the United States. Surplus notes are closely regulated and deeply subordinated to policyholder claims, and, therefore, are reported as part of policyholders' surplus despite their debt-like features.

The authority to issue surplus notes and make interest payments is generally part of state insurance statutes or regulations. Surplus notes' legal characteristics vary slightly from state to state; however, most state regulations provide that such capital instruments be reported as policyholders' surplus and not debt only if the surplus note is subordinate to policyholders' claims, other claimants, and all other classes of creditors (other than surplus note holders) in the event of liquidation. In addition, interest payments and principal repayments require prior regulatory approval in the insurer's state of domicile. The notes also are part of an insurer's total adjusted capital under risk-based capital ratio calculations.

Generally, U.S. statutory accounting principles (SAP) allow insurers' investments in surplus notes to be treated as admitted assets, with their value determined by the Securities Valuation Office of the National Association of Insurance Commissioners (NAIC).

Given the historical context of surplus notes and their unique place in an insurance company's capital structure, this criteria procedure highlights both the considerations that determine the treatment of surplus notes within the balance sheet strength assessment and A.M. Best's approach to rating surplus notes issued by insurance companies.

B. Balance Sheet Strength

Considerations of Surplus Notes

The evaluation begins with an examination of the specific terms and conditions of the surplus notes. This entails comparing the surplus note features to the characteristics of pure equity and debt instruments. The features and provisions that can be evaluated include, but are not limited to, the following:

- Term: Maturities/scheduled maturities

- Call provisions
- Subordination
- Step-up rates
- Deferral features: Optional/mandatory payment of interest or principal
- Cumulative/non-cumulative coupon payments
- Replacement language
- Alternative payment mechanisms
- Conversion features
- Default event language
- Other investor/creditor covenants

A.M. Best will review these features of the surplus notes in a collective way to assess the equity content of the issue. This is dictated by:

- Permanency: Is the note available to pay losses when needed? Is it held to maturity?
- Servicing: Are interest payments deferrable in general or when a company is in distress?
- Structure & Subordination: Is loss protection provided to policyholders and other creditors?

Surplus notes that A.M. Best typically views as equity-like have the following characteristics:

- Long-term (typically has a remaining maturity of more than 10 years);
- Subordinate to policyholders, claimants, beneficiary claims, and other classes of creditors, other than surplus note holders; and
- Interest payments and principal repayments subject to regulatory approval.

Regulatory View

A.M. Best recognizes the regulatory view and environment of the issuer's domicile as part of the assessment of the equity content of the surplus notes. A.M. Best considers the following:

1. Whether regulatory approval is sought before the issuance of the surplus notes;
2. The amount of surplus notes allowed as policyholders' surplus by the regulator;
3. The provisions for regulatory approval of interest and principal payments; and
4. The provisions for regulatory approval to redeem and replace surplus notes.

A.M. Best takes a positive view of the above items when they are reflected in state insurance statutes of the issuer's domicile. There is a history of regulatory actions during a period of insurance company stress/default in which surplus notes performed the role of equity capital with respect to priority of claims during liquidation and also served as a form of loss-absorbing capital.

Management Intent

A.M. Best examines both management intent and the intended use of funds in evaluating surplus notes. Management should intend that the surplus notes will be part of the company's long-term capital used to satisfy policyholder and other senior claims during a stress period, and should make the surplus noteholder aware that the note may be subject to potential loss.

Quality of Capital

A.M. Best looks more favorably upon surplus notes when the notes are issued by a new company with a clean balance sheet—a start-up with no business activity—or by an active company to fund profitable business while maintaining conservative underwriting leverage. Conversely, a troubled company using the proceeds of surplus notes to repair an unprofitable book of business could create further problems for the insurer even when capital has improved in the short run, since the inherent defects in the book of business remain unaddressed and there is now an added interest obligation.

While there is no stated limit for surplus notes in the capital structure, and some regulators view the use of surplus notes as favorable, excessive reliance on surplus notes would generally be viewed as a weakness in the quality of capital analysis.

Treatment of Surplus Notes in BCAR

The baseline Best's Capital Adequacy Ratio (BCAR) model initially deducts all surplus notes from the operating insurer's reported statutory surplus. After reviewing the surplus note's features and other qualitative considerations mentioned earlier, A.M. Best determines how much capital credit should be given for the surplus note in the BCAR analysis. The maximum amount of capital credit that can be given in BCAR is 90% for third-party (externally held) notes and 95% credit for notes held by affiliates. The higher credit for notes held by affiliates is based on the assumption that affiliated companies would be more willing to modify the terms of the original surplus note to prevent a credit event. A.M. Best views surplus notes as a permanent form of statutory capital, recognizing the regulatory protection in the event of adverse conditions. The maximum amount of capital credit granted in BCAR will be recognized for up to five years before the surplus note's stated maturity. Credit then will be reduced 20% per year on a straight-line basis until the surplus note reaches its maturity date. The reduction in credit is recognition of the fact that as maturity approaches, the notes represent less of a company's surplus as they must be repaid in full or substituted with other forms of capital at that time.

Treatment of Surplus Notes in the Financial Leverage Calculation

Operating Insurance Companies

Financial leverage at an operating insurer is evaluated on an adjusted and unadjusted basis. On an adjusted basis, surplus notes in the operating company financial leverage calculation may receive equity capital credit in an amount up to 20% of a firm's total capital and equal to the credit the surplus note received in the BCAR calculation. The portion of the surplus note considered debt, plus preferred stock, plus any other borrowed money, is evaluated relative to capital.

Non-Operating Holding Companies

When financial leverage is evaluated on a consolidated (non-operating) holding company basis, surplus notes receive no equity credit because assets at a U.S. insurance operating company are not readily available to fulfill holding company obligations, given the control exercised by the insurance company's regulator.

Additionally, surplus notes held at an operating company within a holding company structure may be eliminated when consolidating financial data up to the holding company. However, any obligations to service surplus notes anywhere within the organization need to be reviewed as part of the overall balance sheet strength assessment.

C. Rating Surplus Notes

Ratings of surplus notes are notched from the published Issuer Credit Rating (ICR) of the operating company. The notching reflects the subordination of the surplus noteholders to the most senior creditors of the insurance company, the policyholders. The regulatory framework and control that insurance regulators have over surplus notes is viewed positively in terms of strengthening an insurer's capital position in a time of stress. The determination of the surplus note rating may encompass an evaluation of other factors, which could supersede the adjusted and unadjusted leverage guidelines. These factors include interest coverage, quality of capital (recognizing the deep subordination and the regulatory control of surplus notes compared with straight debt), financial performance, business profile, and risk management.

For higher rated insurers, surplus note ratings are typically rated two notches below the operating company ICR. However, for issuers at the lower rating levels, notching between policyholder and surplus note 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 (**Exhibit C.1**).

Exhibit C.1: Guidelines for Notching From Operating Company Issuer Credit Rating to Surplus Note

Issuer Credit Rating	Surplus Note Notching
bbb- or higher	2 or 3
bb+ or lower	3 or more

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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 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.

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