October 2, 2024

Best's
Methodology and Criteria

Rating Surplus Note and Insurance Trust-Preferred CDOs

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Outline

A. Market Overview
B. Rating Considerations
C. The Assignment of a Rating

The following criteria procedure should be read in conjunction with *Best's Insurance-Linked Securities & Structures Methodology (BILSM)* and all other related BILSM-associated criteria procedures. The BILSM provides a comprehensive explanation of AM Best's rating process for insurance-linked securities and insurance-linked structures.

A. Market Overview

The securitization of surplus notes (SNs) and insurance trust-preferred securities (ITPS) into insurance collateralized debt obligations (known as SN/ITPS CDO) offers a funding source for small to medium-sized insurance companies that find it cost prohibitive to issue capital on their own behalf. Surplus notes are attractive to issuers for two primary reasons, interest is tax deductible, and they generally increase surplus. ITPS are attractive to issuers because dividends paid are generally tax deductible and ITPS may receive some level of equity credit in the rating analysis as described in the *Best's Credit Rating Methodology* (BCRM) and its related criteria procedures. This criteria procedure outlines AM Best's process for rating CDOs backed largely by insurance company debt, although the collateral in the transactions may also contain bank debt.

General Transaction Structure and Features

The notes in SN/ITPS CDOs typically are co-issued by two stand-alone, special-purpose vehicles (SPVs) – one incorporated in the United States and the other incorporated in a tax-friendly jurisdiction. The SPVs have no prior operating experience and are limited to acquiring the portfolio of assets, issuing the notes and engaging in certain related activities.

The notes issued by the typical SN/ITPS CDO generally consist of long-dated senior and mezzanine notes and an equity tranche. Proceeds are generally used to purchase the transaction's collateral, which consists of surplus notes, insurance trust-preferreds and a small number of senior notes. In the transactions rated by AM Best, the collateral not only includes newly issued surplus notes and insurance trust-preferreds maturing in 30 years, but also long-dated senior notes and insurance obligations purchased in the secondary markets. This criteria procedure will only refer to the collateral as consisting of newly issued surplus notes and insurance trust-preferreds, unless otherwise stated.

Interest and principal payments to noteholders in a SN/ITPS CDO are derived primarily from the collateral's interest and principal proceeds. To avoid an event of default, the senior notes in the

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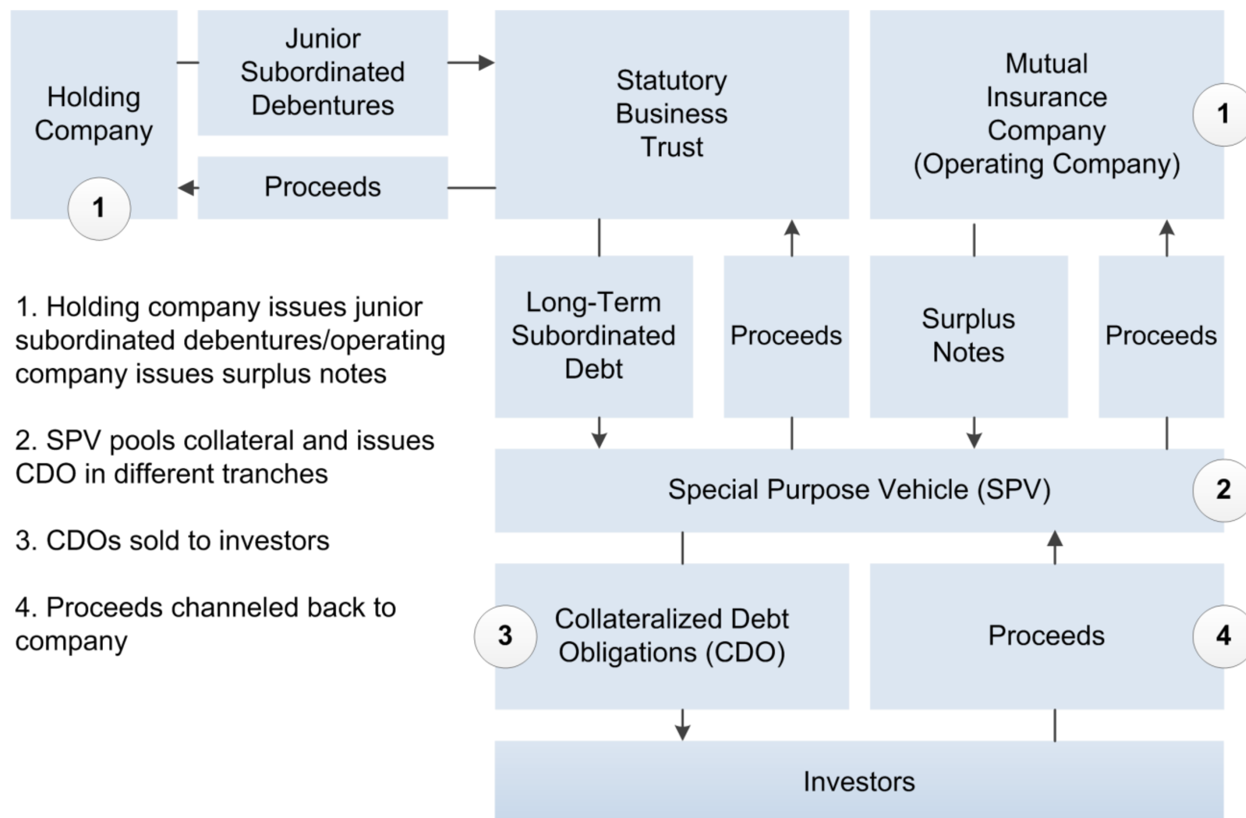
transaction generally must receive interest and principal when due. Interest on the mezzanine notes, however, may be capitalized if there are insufficient funds to pay the amount due. The equity investors generally are entitled to receive all excess funds under certain conditions. In some structures, the equity investors have a cap on their returns for a specified period.

The collateral in a SN/ITPS CDO generally consists of about 30 or more newly issued surplus notes and insurance trust-preferreds that are non-amortizing and due in 30 years. Other types of insurance-related collateral, such as surplus notes and insurance trust-preferreds purchased in the secondary markets, generally have maturities less than 30 years, and are relatively small compared with the newly issued surplus note and insurance trust-preferred balances.

Description of Trust-Preferred Securities and Surplus Notes

Generally, the insurance companies that issue the surplus notes and ITPS are small to medium-sized insurers domiciled in the United States and typically maintain, a minimum AM Best Issuer Credit Rating of “bbb-”. The size of the collateral pools normally ranges from USD 300 million to USD 500 million. A majority of the collateral consists of primary issuances, with the remainder derived from the secondary market. All the collateral pools for the SN/ITPS CDOs rated by AM Best to date have been static pools, thereby lessening the importance of the collateral manager. Details of the basic features of SNs and ITPS are illustrated in **Exhibit A.1**.

Exhibit A.1: Surplus Notes/Trust-Preferred Pool Structure Example



Surplus Notes

Surplus notes are generally issued directly by a mutual insurance company. As unsecured obligations, they are subordinate in right of payment to all senior indebtedness and policy claims of the issuer (the insurance operating company). Typically, no restrictions limit the issuer from incurring additional senior indebtedness. In addition, each payment of interest and principal under a surplus note is subject to the approval of the appropriate state regulator. Any failure by the issuer to make a payment of principal or interest due to a disapproval of such payment by a state regulator does not generally constitute an event of default under the surplus note's legal documents.

Insurance Trust-Preferreds

The insurance trust-preferred issuer is normally organized as a statutory business trust whose insurance holding company owns all of its beneficial interest. The insurance holding company issues a junior subordinated debenture to the trust that, in turn, issues an insurance trust-preferred (i.e., Long-Term Subordinated Debt) to the SPVs used in the SN/ITPS CDO. The terms and conditions under the junior subordinated debenture mirror those under the insurance trust-preferred; thus, the trust acts as a "pass-through" structure for the interest and principal payments. The insurance holding company is obligated to ensure that payments made to the statutory trust under the subordinated

debenture will be paid to the SPV, but it is not obligated to make payments to the statutory business trust.

The payments received from the parent holding company under the junior subordinated debenture are the only source of funds for payments on the insurance trust-preferred security. The junior subordinated debenture is a subordinated debt instrument of the parent holding company. No restrictions limit the holding company from incurring additional senior indebtedness. The holding company is allowed to defer interest payments under the terms of the junior subordinated debenture for a total period of five years. The deferral of interest payments to the junior subordinated debenture will result in the deferral of interest payments to the insurance trust-preferred, thus decreasing the amount of cash available to the SPV to make payments on the notes.

B. Rating Considerations

Protection for the Noteholders

AM Best considers the structural protections inherent to the notes of SN/ITPS CDOs in the rating process. These features may include: coverage tests; amortization of notes in the event of defaults/deferrals; a required auction of the collateral beginning in the 10th year; a mandatory diversion of a portion of the cash flow from equity holders to senior and mezzanine noteholders after each failed auction; and the equity holder's option to purchase the entire pool of collateral and/or the defaulted/interest-deferred collateral.

Coverage Tests

Principal and interest coverage tests often are employed as mechanisms for deleveraging (i.e. reducing the rated note balances) the transaction. The triggers usually are set such that in the event of excessive impairments of the collateral, the payments to senior noteholders are accelerated. The coverage tests, as described in the indenture, are included in AM Best's modeling of the transaction.

Amortization of Notes Due to Defaults/Deferrals

In some structures, if defaults occur in the collateral pool, the cash flow that ordinarily goes to the equity holders is diverted to amortize the most senior notes outstanding, thus deleveraging the transaction. Such amortizations generally continue on each payment date until the total amount of the diverted cash flow is equal to the principal balance of the defaulted collateral. Other structures depend entirely on their coverage tests and the remedies prescribed in the event of failures of such tests to divert cash flow to the senior noteholders.

The interest on the insurance trust-preferreds can be deferred for up to five years. Typically, SN/ITPS CDOs consider collateral on which interest is deferred as securities in default, even though such deferrals are permissible and not considered an event of default in the indenture of the deferrable interest debentures. For some structures, in the event of interest deferrals, the cash flow that ordinarily goes to the equity holder is diverted to amortize the most senior notes outstanding until the diverted cash flow is equal to the principal balance of the interest-deferred collateral.

Auction Call Redemption

Commencing on the 10th anniversary, the trustees in the transactions are generally required to periodically solicit bids in an auction of the collateral. The trustee accepts the highest bid if that bid is at least equal to the sum of the principal balance of the senior notes, the mezzanine notes, the accrued and unpaid interest on the notes, and other specified expenses. The proceeds from the auction would be used to fully retire the notes, with any excess funds accruing to equity investors. For its analysis, AM Best assumes the notes will be outstanding for the entire 30-year period.

Equity Investor Refinancing

Under some structures, with the concurrence of a majority of equity investors, in year 5 through year 10, the equity investors can purchase all of the collateral from the SPVs as long as the proceeds from the sale repay the existing noteholders. The trustee will accept the highest bid submitted as long as the bid repays the existing noteholders. In addition, after year 10, a significant percentage (generally 60% or more) of cash flow will be diverted from the equity investors to prepay the noteholders. These structural features make it unlikely that the CDO facility will remain in place until its scheduled maturity of 30 years. Nonetheless, AM Best evaluates a structure with this feature as if it were to remain outstanding until the stated maturity date, given that the trustee may not find a buyer for the collateral pool.

Interest Rate Hedges

Interest rate risk is present in all structures, given the fixed/floating nature of the collateral and notes. Interest rate hedges and/or interest rate caps are normally used to mitigate this interest rate mismatch; however, there always is the risk that an unhedged mismatch still may occur. AM Best, through sensitivity analysis, evaluates the potential unhedged mismatch and its impact on the structure's cash flows. AM Best expects any swap counterparty or hedge provider involved in the transaction to have an issuer credit rating.

Other Features

In some structures, once the equity investors receive a predetermined yield, any excess cash is used to repay the noteholders. Other structures have a feature that prevents cash from being distributed to the equity investors if a collateral security is in default. Distributions to the equity investors will not resume until the principal amount of the defaulted security has been paid to the noteholders via the diverted cash. This cash-diversion feature is fully considered in AM Best's modeling of the transaction.

Modeling and Stress Testing

AM Best applies the Monte Carlo simulation process in the CDO Model to analyze the cash flows of SN/ITPS CDOs. To determine the cash flow of each SN and ITPS, AM Best expects to review specific information with regard to the collateral pool, such as issuer name, Issuer Credit Rating (ICR) of the issuing entity, type of security, principal amount, yield, tenor, and other information necessary for modeling the transaction. A copy of the most recent draft indenture or offering circular is reviewed to model the specific features of the SN/ITPS CDO.

Applying Assumed Default Rates

AM Best assigns default rates associated with issuers of collateral in SN/ITPS CDOs based on *Best's Idealized Issuer Default Matrix* as displayed in BILSM. For an insurer rated by AM Best, the assumed default rate associated with its ICR is used as a proxy for its default probability. AM Best assumes that the default probability of all obligations – insurance policy, contract obligations, and debt obligations – of a given insurance company are the same. Therefore, the only distinguishing characteristics of the obligations are the applicable recovery rates, which are addressed later in this criteria procedure.

If an issuer is not rated by AM Best, the long-term unsecured debt rating assigned by another rating agency, if known and available, will be applied to the surplus note, insurance trust-preferred security, senior notes, or other unsecured debt. Entities with no ratings from any rating agencies, and that have not become impaired in the past, will generally be assigned an ICR of "bb+." Insurance companies and other entities that are not rated and have become impaired in the past (and recovered from such impairment) will be assigned an ICR of "b."

Correlation

AM Best assumes impairments on small to midsize insurance companies are largely uncorrelated. However, in times of economic stress, AM Best will increase default probabilities in stress scenarios to reflect the effect of any default correlations that may be inherent in the collateral pool of SN/ITPS CDOs.

Recoveries

The historical data available on the recoveries on surplus notes and insurance trust-preferreds are limited because of the small number of insurance companies that have issued such securities. In addition, because the securities are generally not publicly traded, recovery values after impairments cannot be observed easily. For SN/ITPS CDOs rated by AM Best, the recovery percentages have been quite low and no consistent recovery pattern is evident. For this reason, AM Best will apply zero recoveries in the analysis to the defaults associated with surplus notes, trust-preferred securities, or any other junior debt in the SN/ITPS collateral pool.

Monte Carlo Simulation

After assigning default probabilities to surplus notes, insurance trust-preferreds, and other securities in the transaction, each asset in the collateral pool is modeled individually using the Monte Carlo simulation technique to determine whether the issuing entities are in default. AM Best tests the debt and interest-repaying capability of the collateral pool over a large number of scenarios. Any missed mandatory payment of interest or principal in a given scenario is recorded as a default.

Stress Scenarios

The most important factor that AM Best stresses in the SN/ITPS CDO is the default rates of the issuing entities – both insurers and non-insurers. Recoveries are assumed to be zero as discussed earlier. The following is a list of some of the stress scenarios applied to the transaction:

- Ratings of issuing entities with negative outlooks or that are under review with negative implications are downgraded by up to two notches, depending on the economic outlook for the industry of such entities
- Entities with ratings below "bbb-" or with no ratings are defaulted regardless of whether they are making interest payments
- Marginal default rates applied to the collateral are multiplied by a factor of up to 250% to account for the fact that the default rates represent averages (over several economic cycles) and that peak default rates (particularly for insurers) can be much higher than is represented in the default table applied to the transaction

C. Assignment of a Rating

The default probability – number of defaults divided by the number of scenarios – is tabulated and compared with *Best's Idealized Issue Default Matrix,* as displayed in BILSM. This risk modeling process is discussed further in BILSM. While the calculated default probabilities associated with the securities being rated are a good starting point for the evaluation of the credit risk, other qualitative factors are also considered in the rating process such as: the general economic outlook of the insurance and banking industries; changes in subordination levels; the adjacency of very high investment-grade ratings to very low non-investment-grade ratings in the transaction's capital structure; the effect of interest-rate spikes; the effect of unanticipated, incremental defaults after the diminution of the collateral pools due to redemptions; and the possibility that redemptions by highly rated entities will leave lower rated companies in collateral pools.

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

METHODOLOGY AND CRITERIA

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Version 011624