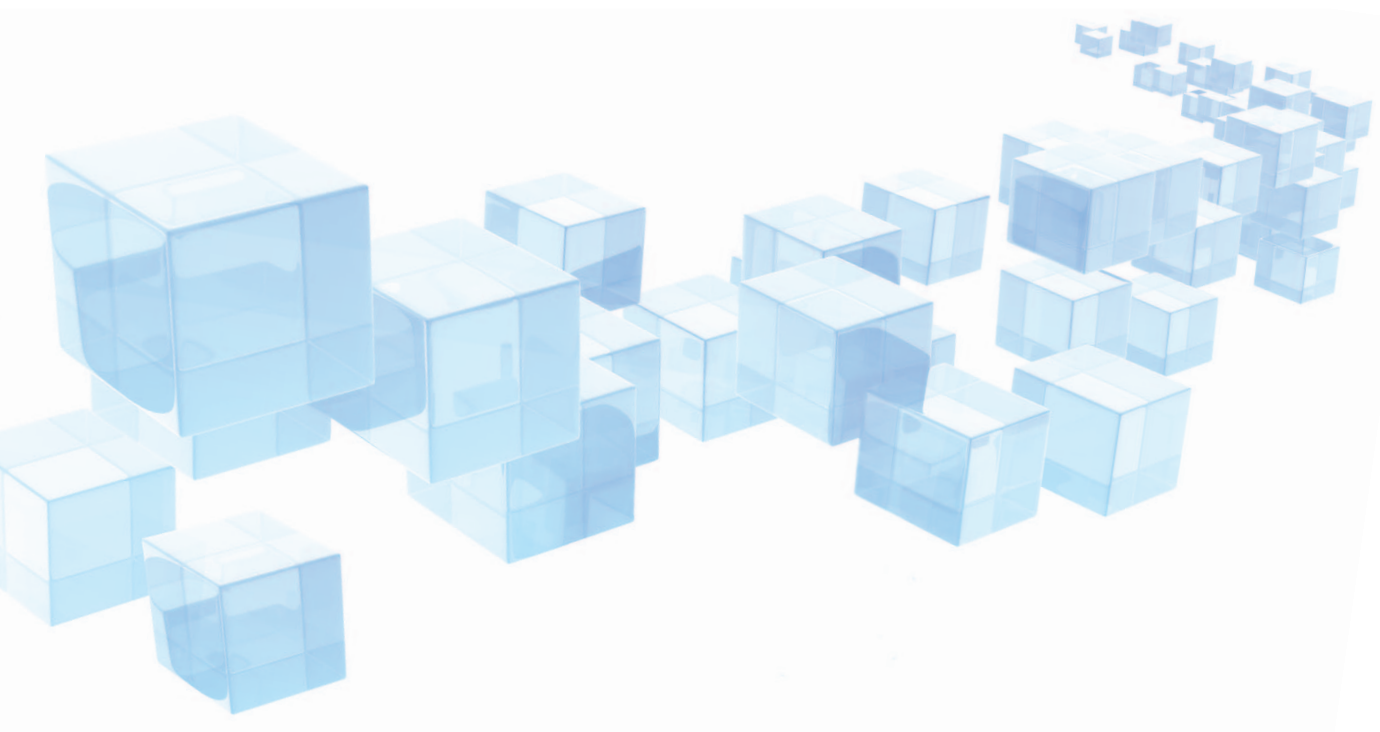


Available Capital and Holding Company Analysis

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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 AM Best's rating process.

A. Overview

AM Best views effective capital management as a key strength for a successful insurance operation. Over time, the tools available to insurers for managing capital have expanded beyond reinsurance and traditional capital instruments to include contingent capital facilities, insurance-linked securities, convergence transactions, and other innovative financial instruments and structures.

Following a brief description of the limits AM Best places on equity credit, this criteria procedure discusses equity credit for capital instruments in the context of financial leverage and explains the key components of how this credit is assessed. It then provides insight on certain ratios that may affect the financial leverage evaluation. The discussion moves into commentary on operating leverage, which includes topics such as credit eligibility, activities receiving credit, other considerations that could factor into the assessment, and limits on the amount of credit given.

This criteria procedure also addresses the components of available capital as applied in the Best's Capital Adequacy Ratio (BCAR) calculation. BCAR is in general calculated at both the rating unit and holding company/consolidated levels, as the balance sheet strength assessment includes a review at the rating unit(s) and when appropriate the insurance holding company (HC) level. The document has a two-pronged focus in terms of the capital available to an entity in the BCAR calculation. It details



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the process by which AM Best assesses available capital for the rating unit and—if debt or debt-like instruments are issued by an organization at the parent HC level when the rating unit is not the consolidated group—provides the basis for the level of equity credit given in the consolidated BCAR for the organization.

The starting point for available capital is the financial statements of the entity or entities being evaluated. Capital credit for the rating unit being analyzed is based on the capital held by that rating unit. When considering a rating unit's available capital, the amount of equity credit given will reflect the capital that has been provided to the rating unit itself, not the original source of the funds to the overall organization.

The criteria procedure concludes with additional insight into elements of AM Best's HC analysis. The section is particularly focused on evaluating an HC's liquidity, as this analysis can influence a company's overall balance sheet strength assessment.

Limits on Equity Credit: Financial Leverage and BCAR

Whether a financial instrument receives equity credit affects both a (holding) company's financial leverage calculation and the calculation of its available capital for BCAR. Although many aspects of these two reviews may be similar, the differences mean that treatment may vary, depending on analytical judgment and rating committee review of the particularities of the specific instrument. For example some of the review factors, such as the impact of a certain regulatory scheme, may be weighted more or less; included or excluded; or deemed not applicable based on the specific instrument.

Financial instruments in the form of hybrid securities (such as preferred stock, trust-preferred securities, convertible securities or subordinated debt) share some basic characteristics associated with common equity. Hybrids can include a variety of features that, over time, change the proportions of debt and equity.

In general, AM Best grants equity credit for hybrid securities with the characteristics of common equity in an amount up to 20% of a firm's total capital and total available capital in the financial leverage calculation and BCAR respectively. The amount of credit given to hybrid securities is based on AM 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. This sensitivity may expose issuers to sudden changes in their ability to generate revenue/earnings, in their cost of capital and/or a diminished ability to access the capital markets. As such, AM Best takes a conservative view on both the amount of equity credit an individual security may receive and on the amount of aggregate credit an issuer may be granted, as volatility in these amounts could cause pricing disruption. Additionally, AM Best calculates coverage ratios that include hybrid obligations.

For the BCAR calculation, AM Best looks to measure what sources (including the equity credit associated with various capital instruments) are available to pay policyholder claims under normal

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business conditions and in the event of stress, for which off balance sheet sources and other funds may be available. This BCAR assessment may take place at the rating unit and/or consolidated level.

Identification of holding company capital resources is also a key part of the analysis. Measuring financial leverage at the holding company level entails determining the amount of equity credit given to various capital instruments. Accordingly, AM Best analyzes the features and characteristics of all securities in an issuer's capital structure and may adjust reported balance sheet financial leverage by giving, or possibly removing, equity credit for certain instruments.

B. Leverage

Financial Leverage

AM Best evaluates a rating unit's total leverage, which includes financial and operating leverage, as part of forming an overall opinion of balance sheet strength. Financial leverage, through debt or debt-like instruments, may place a call on earnings and strain an insurer's cash flow. Conventional balance sheet treatment of certain types of securities based on financial statements does not always yield a true picture of an organization's risk or financial leverage. For instance, an issuer may have a large portion of reported equity in the form of callable preferred stock, which may have a relatively short time to redemption. Conversely, an issuer may report a relatively large debt issue on its balance sheet that can and will be converted to common equity over a short period of time. The former potentially exposes the insurer to a major liquidity or credit event, while the latter will eventually result in improved financial flexibility.

Regardless of its form, excessive leverage may affect an insurer's liquidity, cash flow, and operating profile and could lead to financial instability, particularly during times of systemic stress in the capital markets. The leverage evaluation can have a positive, neutral, or (very) negative impact on the initial balance sheet strength assessment.

High financial leverage may lead to financial instability. As such, the analysis of financial leverage in the capital structure is conducted at both the rating unit level and, if applicable, at the holding company/consolidated level; this allows AM Best to determine if both balance sheets are sound and unencumbered.

Qualitatively, factors such as where the debt is issued vs. where the cash is used, restrictions on fungibility, the existence of other sources of income to service the debt, fixed-charge coverage, and the overall level of debt relative to the organization's total capital are all considered.

Key Equity Credit Components of Capital Instruments

AM Best's approach to assessing equity credit includes both quantitative and qualitative factors, with each factor assessed along a continuum. These assessments determine how much equity credit a capital instrument may receive. The analyst first considers instrument-specific factors using the capital instrument's prospectus or other offering material, and then adjusts the amount of credit given based on a review of issuer-related factors. Ultimately, the determination of what constitutes available capital

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is subject to analytical judgment; however, the following factors help to determine a security's eligibility for equity treatment:

- Permanence
- Servicing
- Structure & subordination
- Complexity (fungibility/flow of funds/legal structure)
- Management intent
- Regulatory treatment
- Market access/ financial flexibility

Instrument Factors

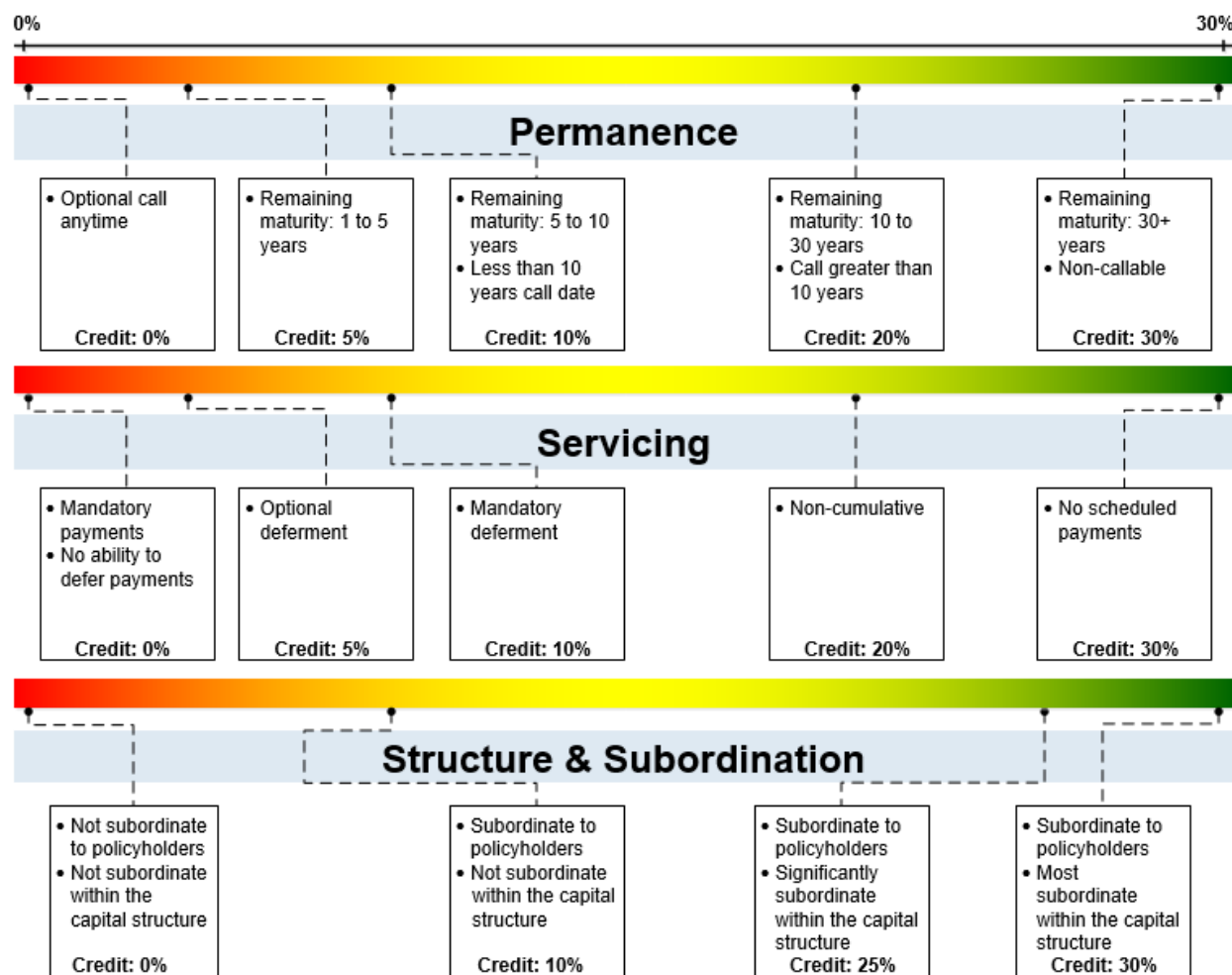
Exhibit B.1 identifies points along the credit continuum for instrument-related factors, namely permanence, servicing, and structure & subordination. The analyst uses the assessments of these three factors to arrive at a baseline credit amount for the instrument. For each of the three, the analyst considers whether the instrument has the characteristics that make it eligible for equity credit. The amount of credit an instrument can receive ranges from none to significant equity credit. The combination of instrument and issuer factors results in the amount of equity credit ultimately given to the instrument.

The characteristics and credit examples listed in **Exhibit B.1** are intended to be general guidelines and assist the analyst in determining equity credit. The many particularities of financial instruments ensure that no chart can be all encompassing.

Senior debt instruments are not considered hybrid securities and no equity credit is awarded under any of the categories.

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Exhibit B.1: The Credit Continuum for Hybrid Instrument Factors for Financial Leverage



The maximum amount of credit that can be awarded for each individual characteristic in **Exhibit B.1** is 30%. Thus, an instrument that is non-callable with a remaining maturity exceeding 30 years, has no scheduled payments, is subordinate to policyholders, and is the most subordinate in the capital structure could receive 90% equity credit (30% for each of the factors).

Permanence

First and foremost, AM Best needs to understand the permanence of the capital instrument. Pure common equity is deemed to be the most permanent form of capital available to absorb losses. Thus, the more equity-like features a capital instrument has, the more equity credit will be granted.

Capital instruments with longer remaining terms to maturity (or no stated maturity) will generally be granted more equity credit; those with shorter remaining terms to maturity or rights to early redemption will be granted little to no equity credit. Capital securities with five or more years remaining to maturity are generally eligible for consideration for equity credit. Instruments that can be redeemed by the issuer will typically receive equity credit only up to the earliest possible redemption date on

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which the issuer can exercise the redemption feature. However in cases where a company or group has demonstrated the ability to refinance similar securities in the capital structure and/or where AM Best views the capital management strategy as creating a sufficient expectation that the issue will either not be called or will be refinanced, higher equity credit may be granted.

Companies that issue securities with early call options that do not regularly exercise the call provision or have a history of replacing instruments with issues of similar characteristics and amount may receive equity credit based on a term longer than the one suggested by the earliest call date. Step-up provisions make it more likely that an issue will be called at a predetermined date, which is usually the first call date. Step-up provisions that are subject to regulatory approval and not legally binding are viewed more favorably. If AM Best believes that there are no plans to redeem the security, higher equity credit may be granted. Securities with replacement language by which the issuer is legally obligated to replace the capital instrument with a similar security in terms of maturity may be considered more favorably for equity credit. The replacement language should specify that the amount of the replacement instrument should equal that of the instrument being replaced to ensure no diminution of the capital position.

The absence of an arrangement that legally enhances the payment claim of the security holder or prioritizes payments during periods of stress is viewed favorably by AM Best in the determination of equity credit. Call features that are linked to events beyond the issuer's control (e.g., change in tax treatment) or that prevent default acceleration will also be evaluated and may be viewed unfavorably.

AM Best will also review any put options in the capital structure that grant investors the right to early repayment. Instances in which the issuer is forced to redeem the capital instrument will be viewed more negatively in the evaluation.

Servicing

AM Best views capital instruments without mandatory servicing requirements as more equity-like. The option to defer/skip interest and/or principal payments without triggering a default or penalty provides flexibility for the issuer. Greater consideration is given for capital securities that have mandatory deferral of interest payments or distributions. The analyst also reviews alternative mechanisms for payment (e.g., payment in kind securities instead of cash) to assess whether they may enhance financial flexibility.

Non-cumulative provisions are viewed as more equity-like compared with cumulative provisions. Under non-cumulative arrangements, skipped coupons are canceled and not paid, while cumulative coupon payments are accumulated and can be paid at a later date. AM Best will review the terms and conditions on which servicing payments may be skipped. For example the level of solvency at which interest and/or principal payments may be skipped is considered.

Dividend stoppers – which legally require the issuer to defer payments on other securities if the insurer does not pay a dividend on a particular security – could be viewed favorably for servicing purposes.

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Clauses that could accelerate or cause stress on an insurer's financial condition such as early repayment on failure to pay a coupon, would be viewed negatively.

Structure & Subordination

The priority of payment in the flow of funds determines the payment structure/hierarchy of the capital instrument. Payment of principal and interest must be subordinate to policyholder claims to be eligible for equity credit. AM Best looks beyond the nomenclature of the security (such as senior, subordinated, or junior subordinated) to determine the true subordination characteristics of the capital instrument. AM Best reviews the terms and conditions of securities issued and the maturity schedule, if any. Those instruments that represent the most subordinated claim in liquidation will likely receive the highest level of equity credit for this factor. AM Best views instruments that are legally subordinated to policyholder claims, general creditors, and other debt holders of the insurer favorably in the equity credit analysis. Features such as contingent write-downs, conversions into equity, or a more subordinated type of security are reflective of more equity-like features. AM Best also reviews features that add complexity or reduce clarity in relation to a security's performance (such as step-ups) and notes that these features tend to reduce equity credit.

Analysts review debt covenants to understand restrictions in the offering such as future borrowing limits as well as default event language to determine what constitutes the occurrence of a default event.

Other Considerations

Loss Absorption

AM Best also considers any loss absorption characteristics of a financial instrument when assigning equity credit. The ability to absorb losses can be diminished by short-term demand features exercised by investors. Instruments with high loss absorption and legal documents stating that the instrument has the ability to be written down or converted to equity will likely receive more equity credit. The order of loss-absorbing capacity of the instrument, as well as any impact from recapitalization, should be clearly stated in the documentation.

Issuer Factors

Equity credit for a security may diverge from the guidelines in **Exhibit B.1** depending on other elements. After reviewing the instrument-specific factors, the amount of equity credit given may be adjusted by a qualitative review of the issuer-related factors: complexity, management intent, regulatory treatment, and market access/financial flexibility (**Exhibit B.2**). Depending on the assessment of these factors, the ultimate amount of equity credit awarded may differ from the amount suggested by the initial review of instrument-specific factors.

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Exhibit B.2: Issuer Factors

	Negative	Neutral	Positive
Complexity	•Problems have arisen when trying to move funds between entities •Complex structure makes flow of funds difficult	•Uncertainty on free flow of funds •May need to move funds between more than 1 entity	•No restrictions on free flow of funds •No regulatory barriers to capital movement
Management Intent	•Issues have been called early & not replaced in capital structure •High leverage appetite beyond tolerance	•Generally adheres to leverage tolerance, may breach on occasion •No track record of replacement	•Consistent capital management approach within tolerances •Replacement of called security with similar characteristics
Regulatory Treatment	•Not recognized by regulator as loss absorbing	•Regulator can force conversion to equity	•Regulator recognizes the instrument as equity
Market Access/ Financial Flexibility	•Weak coverage and high leverage •Limited access to capital markets	•Moderate leverage •Adequate coverage •Access to markets at a premium	•Proven access to capital markets •Strong coverage/low leverage

The characteristics described for each category are ideal scenarios and are not intended to be prescriptive.

Complexity

Fungibility/Flow of Funds/Legal Structure

AM Best needs to understand what, if any, restriction there may be on the free flow of capital among legal entities. AM Best reviews the legal structure of the enterprise to understand the flow of funds. More complex organizations may own multiple insurance and non-insurance entities and the ability to move funds may be constrained or unclear.

Management Intent

While AM Best reviews the structure and maturity of the capital instrument, management's intentions and track record also constitute an important part of the evaluation. Future equity credit may be

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reduced for new or existing securities in the capital structure if capital instruments have been redeemed/called early and have not been replaced with comparable securities. AM Best reviews management's corporate objectives for leverage and its track record of managing to these stated levels. AM Best also considers management's record of using debt for funding insurance operations versus share repurchases or other general corporate purposes when reviewing eligibility for equity credit.

Regulatory Treatment

AM Best looks for any regulatory impediments to payment which strengthen the capital position of the insurer in times of stress. In such instances, if the regulator for example has authority to prevent the early redemption of the capital instruments, AM Best views this favorably in the equity credit analysis. A further example would include the need to have regulatory approval in order to make the note's scheduled principal and interest payments.

AM Best expects eligible instruments to be recognized by the local regulator even if the instrument is issued in another jurisdiction. Any triggers to convert capital instruments into equity when under the purview of regulatory discretion should be clearly defined in the instrument's legal documents and allow for sufficient cushion well before an entity is impaired, with limited lag time for the conversion to occur. Instruments not recognized by regulators would likely be excluded from BCAR available capital, although they may be eligible for equity credit in the calculation of financial leverage.

Market Access/Financial Flexibility

Exceeding the limits on leverage (as shown in **Exhibit D.1**) will have a negative impact on an insurer's overall balance sheet assessment. The amount of equity credit will be reduced as the level of total leverage increases beyond AM Best's comfort level. In addition, companies in financial distress may not receive equity credit, given the potential limitations of the market's acceptance of future issuances. In the event of a shock loss—owing to a catastrophe, for example—insurers may find it difficult to recapitalize at a reasonable cost. This results in limited financial flexibility for the group.

Typical Hybrid Securities

The following section provides a brief overview of the major classes of hybrid securities that typically warrant equity credit.

Traditional Preferred Stock

Generally viewed as the original form of a hybrid security, preferred stock pays a stated dividend yield, much like the coupon paid on bonds, but is unlike common stock in that it typically does not confer voting rights. Holders of preferred stock also have certain preferences or priorities over holders of common stock as to dividends and/or distribution of assets in the event of bankruptcy or liquidation.

Preferred stock is issued directly by a holding company or operating company and can include equity-like features such as:

- Perpetual maturity, with no put options that present refinancing or repayment risk
- Deferrable ongoing payments
- Deep subordination, senior only to common stock

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While some forms of preferred stock, such as a perpetual noncumulative issue, may receive equity credit, other forms may receive little to no equity credit. For example, issues with a short time to redemption expose the issuer to refinancing or repayment risk. The issuer also may elect to replace these deeply subordinated obligations with securities having a more senior claim in the overall capital structure. Also, there is a risk that the organization may not be able to issue new securities to repay maturing issues.

Convertible Securities

Convertible securities typically can be converted into shares of a company's common stock. For this reason, the issuance of convertible securities typically is seen as demonstrating management's readiness to issue equity in the future. In general, these instruments can be grouped into two broad categories: mandatory conversion and optional conversion.

In a traditional, mandatorily convertible security, the conversion formula is fixed; that is, the instrument automatically converts upon maturity into common stock based on a fixed price. Such instruments are equity-like since there is no obligation to return cash to investors at maturity. Furthermore, equity benefit increases progressively as maturity approaches, particularly if it is clear that the equity will remain a permanent part of the issuer's capital base. Thus, these securities have characteristics that would generally provide greater equity credit, while securities with a floating conversion rate are viewed as more debt-like. Other variations of mandatorily convertible securities include those that convert into a:

- Fixed number of common shares when issued, which protects the issuer from potential earnings per share dilution
- Number of shares that equals the principal amount owed to the investor, which may expose the issuer to significant earnings per share dilution should its stock price become depressed at the time of maturity

In general, a convertible security issue allows the issuer to benefit, by offering lower dividend or interest rates, which enhances the issuer's fixed-charge coverage ratio.

Typically, optionally convertible securities can convert into a fixed number of common shares at the option of the investor. When reviewing such issues for potential equity credit treatment, AM Best looks for provisions that include an issuer's call feature, exercisable after a given period, requiring conversion. Without the call feature, it is unlikely that investors would forego the benefit of continuing to receive dividend payments on "in the money" securities. Similarly, contingent capital securities are reviewed to understand the trigger mechanisms for conversion into equity as part of the equity credit evaluation. Analysts can evaluate market conditions for either the call or trigger mechanisms to factor in the likelihood of their occurrence.

Optionally convertible securities typically include the following:

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- Conversion into common shares from issue, which makes it closely resemble common equity's no-maturity characteristic; however, although these securities typically do not have a repayment issue, they represent a subordinated claim in the event of default or cross default
- Deferrable dividend or ongoing cash payments
- Subordination in the capital structure

Trust Preferred Securities

Trust preferred securities, which include issues such as MIPS (Monthly Income Preferred Stock), QUIPS (Quarterly Income Preferred Stock), and TOPRS (Trust Originated Preferred Redeemable Stock), have the characteristics of both debt and equity instruments. These hybrid securities allow an issuer to make tax-deductible interest payments, which reduce the issuer's cost of capital while also providing equity-like benefits similar to traditional preferred stock.

Trust preferred securities generally are issued by a special-purpose trust created by the parent company. The trust lends the proceeds to the parent, typically through a subordinated loan that is junior to all other debt of the parent. The terms of the preferred securities match the terms of the underlying subordinated loan.

Payment obligations of the trust typically are guaranteed through several agreements and by the terms of the debt securities that the trust holds. The agreements normally include a guarantee and an expense undertaking from the parent company, the trust indenture for the debt securities the trust holds, and the trust declaration of the trust itself.

Trust preferred securities typically have the following features:

- Long maturity, between 20 and 40 years, with an issuer call option after five years. As such, it is an obligation that must be repaid from cash flow or refinanced.
- Deferrable dividends, subject to suspension of common dividend, for up to five years without triggering a default. Deferred amounts accumulate, accrue interest, and must be paid before resuming common dividends or at the end of the limited deferral period.
- Subordination to all debt obligations of the parent and parity with other directly issued trust preferreds. Due to the loan structure underlying the issued security, in liquidation it has a more senior claim to preferred stockholders.
- Default triggers whereby, as a debt claim, it is an obligation that could become due immediately in the event of a default, cross default, bankruptcy filing, or other form of reorganization. Also, the existence of a call option would raise the possibility that the instrument could be replaced in the future with a new issue, with no guarantee that the refinancing will be neutral with respect to senior creditors in the issuer's capital structure.

Subordinated Debt

Subordinated debt supplements capital without diluting existing shareholders' control and allows the issuer to make tax-deductible interest payments, which reduces its cost of capital. In addition to these

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traditional debt features, these instruments often have equity-like characteristics such as a long or perpetual maturity and deferrable coupon payments.

These instruments generally include the following:

- A stated maturity of over 20 years (often perpetual), with an issuer call option after 5 or 10 years
- Subordination to policyholders and senior debt holders
- Deferrable and non-cumulative coupons

Hybrid Debt Examples

The following examples are illustrative only; actual securities may be treated differently based on specific information in the offering memorandum, along with other factors.

Insurance Holding Company XYZ issues a USD 1B subordinated note with a maturity of 40 years, an option to defer interest, and no early call provision. The offering document indicates that the proceeds may be used for general corporate purposes, which may include contributions to its insurance subsidiaries. The long term maturity coupled with no early call provision indicate significant permanence, allowing credit of 30%, while the subordinated note structure allows 25% credit for subordination. The optional deferment feature is positive, but mandatory deferment and a non-cumulative structure would have resulted in higher equity credit. From a servicing perspective, 5% equity credit is granted.

Company ABC issues a USD 500M subordinated note with maturity of 20 years, a mandatory interest deferral feature, and a first call date in six years. The note is treated as regulatory capital. The company has a history of replacing called securities with similarly structured securities of maturity and type. The analyst therefore treats it as a 20 year note despite the earlier call feature and gives it 20% for permanence. Similarly to the previous note, the subordinated structure is given 25% equity credit for subordination, while the mandatory interest deferral feature results in 10% credit for servicing.

Company 123 issues USD 1.8B subordinated debt with a maturity of 25 years, an option to defer interest, and a first call date in four years. Interest will be deferred if (1) payment results in or accelerates insolvency, (2) regulatory restrictions are put in place, or (3) funds to cover minimum regulatory capital requirements are insufficient. Given the company's track record and intention to refinance the debt with a similar issue, permanence credit of 20% is given by the analyst, despite the four year call option. The additional regulatory feature allows the analyst to treat the deferral as mandatory, resulting in a 10% credit for servicing. After reviewing the prospectus, the analyst gives the issuance 25% credit for subordination.

Company ZZZ issues, for the first time, USD 1B perpetual debt. This debt is deeply subordinate in the capital structure and has a first call date in three years with a step up of 150 bps. Coupons can be deferred at the issuer's option on a cumulative basis, triggered by tax or regulatory events. Given the highest level of subordination in the capital structure (relative to common equity), credit would be

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30% for subordination. However, the step-up feature adds complexity to the instrument. This, along with the early call date and the lack of a track record in replacing called securities, results in credit of 10% for permanence. The optional deferral yields a 5% credit for servicing.

The calculation for typical equity credit given to these examples is illustrated in **Exhibit B.3**.

Exhibit B.3: Hybrid Debt Examples

Company	Permanence	Servicing	Structure & Subordination	Total Equity Credit
XYZ	30%	5%	25%	60%
ABC	20%	10%	25%	55%
123	20%	10%	25%	55%
ZZZ	10%	5%	30%	45%

Typical Financial Leverage Ratios

Crucial to an insurer's balance sheet assessment is its ability to meet the debt service and other obligations in its capital structure. AM Best believes that the effect of hybrid securities on debt-service ability is also a key determinant of debt capacity. In addition to the positive impact these securities may have on operating cash flow through interest-deferral features, cash coverage also can be strengthened materially by the consistency and sustainability of a company's earnings and alternative sources of cash, including cash at the parent holding company level and unrestricted dividends from subsidiaries.

Financial Leverage (Unadjusted): This ratio measures debt to capital before granting equity credit for hybrid securities.

Financial Leverage (Adjusted): This ratio measures debt to capital after granting equity credit for hybrid securities.

Debt to Tangible Capital (Unadjusted): This ratio measures debt to capital, but adjusts capital by subtracting intangible assets such as goodwill and is before granting equity credit for hybrid securities.

Debt to Tangible Capital (Adjusted): This ratio measures debt to capital, but adjusts capital by subtracting intangible assets such as goodwill and is after granting equity credit for hybrid securities.

Typical Coverage Ratios

In evaluating an HC's ability to service its financial obligations, AM Best reviews coverage ratios, which can include interest and fixed-charge coverage. The ability to service financial obligations over time is a function of the organization's current capitalization and capacity to generate earnings from operations.

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Interest Coverage: This ratio compares operating earnings before interest and taxes (EBIT) to interest expense plus non-equity preferred stock.

Fixed-Charge Coverage: This ratio compares operating EBIT to adjusted fixed charges. The rating analyst may review this ratio if it differs significantly from interest coverage and there are concerns about the rating unit's ability to pay its fixed obligations.

Operating Leverage

Generally, the debt portion of an insurer's capital structure is used as working capital for its insurance lines. Operating leverage, however, is viewed as leverage used in normal business operations (insurance or non-insurance) to provide additional sources of operating income with tight duration or cash-flow matching characteristics. These activities also may be program specific (i.e., spread lending) or support non-economic reserves with low levels of liquidity risk, credit risk, and duration mismatch risk.

AM Best will review at an enterprise level total financial leverage to determine the impact on the balance sheet assessment. Reported leverage may be elevated due to the inclusion of operating leverage. When appropriate, the financial leverage position will be lowered by credit for operating leverage. The review of the magnitude of operating leverage may also extend to the rating unit level as needed.

Diversified enterprises with significant non-insurance operations, such as consumer finance, asset management, equipment leasing, and mortgage banking, may require additional funding. If the financing of other operations is to be serviced solely by the non-insurance businesses and meets the outlined eligibility requirements, AM Best likely would consider the debt as operating leverage rather than financial leverage. These businesses usually are not guaranteed by the lead insurance company, and the debt typically is match-funded with corresponding assets such as credit card receivables or mortgages. The impact on organizations with highly leveraged non-insurance operations would be reflected in the overall evaluation of balance sheet strength.

Amounts eligible for operating leverage treatment would generally involve cases in which residual risk to the insurer is insignificant. Because financial instruments may be issued by holding companies or operating companies (or both), AM Best will apply specific tolerances on a consolidated basis. If the tolerance is exceeded, all subsequent operating leverage would remain in the financial leverage calculation. The analyst would closely monitor the issuer's appetite for additional forms of leverage (for example, retail notes and/or institutional spread-based [ISB] products) and may contemplate lowering the entity's balance sheet strength assessment if growth trends vary substantially from previous expectations. From a rating unit level, high concentration in spread business eligible for operating leverage would be viewed through the normal lens of the business profile assessment.

Eligibility for Operating Leverage Credit

AM Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets, finance non-insurance operations, or fund non-economic reserves. Cash flows from the pool of assets should be sufficient to fund the interest and principal payments associated

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with the obligations. Additionally, AM Best expects the insurer to have sound asset/liability and investment risk management capabilities, adhere to low-duration mismatch tolerances, and maintain negligible repayment and liquidity risk related to these obligations. For financing to receive operating leverage treatment, AM Best should be able to (1) analyze the investment policy statement; (2) understand management controls and the structure of the funding mechanism; and (3) review specific provisions related to debt covenants. In addition, if leverage is part of a spread-based program, AM Best expects the spreads to be positive.

Examples of Operating Leverage

Some examples of activities that typically would be viewed as generating operating leverage include the following:

- Securities lending programs
- Repurchase and reverse repurchase agreements (repos)
- Spread-based Federal Home Loan Bank (FHLB) borrowings
- Guaranteed investment contracts (GICs) and funding agreements
- Funding agreement-backed securities programs (FABS)
- Retail note programs
- Premium financing operations
- Letters of credit (LOCs), debt or parental guarantees related to XXX or AXXX reserve financing
- Government programs that introduce leverage to an insurer's balance sheet
- Embedded value securitizations
- Real estate joint ventures
- Other off balance sheet liabilities

Given that capital market financing solutions will continue to evolve, this listing is not meant to be exhaustive. AM Best may review new forms of capital market financing on a case by case basis to determine operating or financial leverage treatment based on its assessment of the underlying, fundamental characteristics.

With respect to closed-block monetizations, AM Best would tend not to view the debt associated with these transactions as operating leverage, particularly if the debt is with recourse. AM Best recognizes the stable, long-term nature of closed-block liabilities and the steady earnings generated by the assets supporting the business, along with the flexibility to reduce future dividends to meet closed-block liabilities. The impact of eliminating the closed block's future earnings and using the debt proceeds in higher risk, higher return businesses will be incorporated in the operating performance evaluation. However, AM Best's tolerance for financial leverage for that company likely would increase, depending on the characteristics of the in-force block.

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Generally, securities lending programs maintain liquid, high-quality investments with tightly matched asset/liability durations and are governed by formal investment guidelines that have established limits for interest rate, reinvestment, and counterparty risks. In these cases, AM Best will permit operating leverage treatment. However, should an insurer demonstrate over-reliance on securities lending or have a track record of incurring collateral-related losses, AM Best may deny operating leverage credit.

FHLB programs provide financial flexibility for insurance company members and are an attractive source of capital because of the low rates offered on advances. For companies that invest the loan proceeds in their core businesses for working capital or use the proceeds as a liquidity or capital backstop, these obligations would be viewed as financial leverage. If FHLB borrowings are being used for spread enhancement activities (i.e., similar to external funding agreements in purpose) and the insurer can demonstrate strong asset/liability and liquidity management expertise, AM Best would view these activities as qualifying for operating leverage treatment. The rationale for this is that these borrowings are similar to other ISB products such as GICs (general account, separate account, and synthetic), funding agreements, FABS, and retail notes.

Another type of debt obligation that AM Best has treated as operating leverage is one that is a component of a securitization (e.g., debt issued to fund XXX and AXXX [non-economic] reserve redundancies). In these structures, the assets are segregated and placed in a Regulation 114 trust for the benefit of the policyholders. The cash flows generated are projected to be more than sufficient to fund the debt payments, i.e., the securitization structure typically contains some overcollateralization. Also, these structures regularly involve the issuance of debt that is nonrecourse to the direct writer through a special-purpose vehicle. Moreover, in recent years companies have increasingly used senior unsecured debt issuances to self-fund XXX and AXXX reserves. In this case, only debt issued by the holding company will be afforded operating leverage credit. However, if there is some recourse to the issuer (i.e., a holding company issues unsecured debt but it contains a feature requiring the posting of additional collateral if the issuer's credit default swap [CDS] spreads widen), these types of issues will not be afforded operating leverage credit.

In some cases, XXX and AXXX funding solutions have used LOCs to fund these reserves. These LOCs have rollover risk, which may increase an insurer's cost or may no longer be available during times of severe dislocations in the capital markets. AM Best will consider operating leverage treatment only for LOCs that have a remaining maturity of five years or longer. If LOCs have near-term rollover risk (i.e., less than five years), they will be considered financial leverage. Some regulators are permitting alternative sources of financing for XXX and AXXX captives in lieu of external financing; AM Best may consider giving these alternatives operating leverage treatment.

AM Best has observed the increased use of embedded value transactions where a block of in-force business has been monetized through issuance of debt to external investors backed by an SPV structure. If such transactions are non-recourse to the holding company, AM Best will generally treat these types of transactions as operating leverage. Those transactions containing some level of recourse to the holding company through a support agreement may be afforded operating leverage treatment,

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pending AM Best's review of the recourse features. However, should the holding company be required to remedy deficiencies (for any reason), any required funding will be treated as financial leverage.

Other Considerations

In its calculation of operating leverage tolerance, AM Best will use a "look-through approach" for off balance sheet liabilities as disclosed in the financial statement footnotes. One type of off balance sheet liability can arise from variable interest entities (VIEs), which are used for investment and asset management purposes. VIEs may or may not be consolidated on an insurer's balance sheet, depending on whether or not the VIE is seen as a passive-type investment activity (i.e., nonconsolidated) or where the company is deemed a primary beneficiary of the VIE (i.e., consolidated). VIEs on an insurer's balance sheet will be reviewed in the following way: If the VIE is consolidated and reflected as debt on the insurer's balance sheet, it will be removed from the financial leverage calculation, assuming that the debt is nonrecourse to the insurer and the risk of loss is limited to the insurer's investment in the VIE. Accordingly, AM Best would typically view financings resulting from the aforementioned activities as operating leverage if the insurer has strong asset/liability, liquidity and investment management skills, and if duration mismatch is kept to a minimum. In addition, nonrecourse debt would be viewed more favorably when calculating a company's financial leverage. Moreover, AM Best will consider the potential volatility of the assets supporting the debt fundings, as well as prospective operating leverage at all rated insurance subsidiaries.

Operating Leverage Limits

AM Best views operating leverage-related activities as reasonable for companies with diverse lines of business, considerable expertise in asset/liability and investment management, and sufficient financial flexibility. However, the greater an insurer's exposure to these liabilities, the greater the potential stress on its liquidity profile, particularly in situations, for example, if a rating is downgraded or a contract contains negative covenants or adverse put options. AM Best expects consolidated operating leverage to be maintained at reasonable levels that reflect current capital market conditions.

AM Best will perform a test at the holding company/consolidated level to determine the full impact of operating leverage treatment on an organization's published debt-to-capital ratio. Further credit for operating leverage will cease once the sum of activities qualifying for operating leverage exceeds 30% of consolidated liabilities, excluding separate-account liabilities. Therefore, debt issued under qualifying operating leverage activities that exceeds this ratio will be subject to treatment as financial leverage in AM Best's calculations.

C. BCAR: Components of Available Capital

Insurance holding companies (IHCs) are discrete and distinct from their subsidiaries and often have no material business operations of their own. The foundation of the analytical approach is the assessment of the IHC on a consolidated basis.

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As part of the balance sheet strength assessment, AM Best may use a consolidated Best's Capital Adequacy Ratio (BCAR) to evaluate risk-adjusted capital using the consolidated financial statements of the IHC or the operating insurance parent company if no IHC exists. **Exhibit C.1** contains the BCAR formula. IHCs with weak risk-adjusted capitalization would be characterized as having “poor financial flexibility” or “limited financial flexibility” as shown in **Exhibit D.1**.

Exhibit C.1: The BCAR Formula

$$\text{BCAR} = \left(\frac{\text{Available Capital} - \text{Net Required Capital}}{\text{Available Capital}} \right) \times 100$$

A company's available capital is determined by making a series of adjustments to the capital (surplus) reported in its financial statements. These adjustments to reported capital are typically on a post-tax basis. They are made to provide a more economic and comparable basis for evaluating capital adequacy and may include recognition of hybrid capital instruments. The credit in BCAR for these capital instruments will be guided by the tenets noted earlier in the discussion of financial leverage and in the **BCAR Hybrid Capital Assessment** section that follows. Different accounting methods and regulatory requirements may also result in adjustments to a company's reported capital.

AM Best's capital model emphasizes permanent capital and consequently will reduce a company's reported surplus for encumbered capital. This reduction, in whole or in part, depends on the magnitude of, and the dependence an insurance group has on, debt-like instruments and their associated repayment features.

Off Balance Sheet Items

AM Best reviews off balance sheet items for capital credit. Some management teams have taken proactive steps toward enhancing their financial flexibility. One popular approach is through contingent capital facilities, which allow companies to preset the terms and conditions of future capital-raising initiatives. Based on the provisions of the facility, AM Best will consider giving qualitative and, in some cases, quantitative credit for contingent capital.

Generally, more credit is given to fully funded facilities, where the special-purpose vehicle (SPV) holds highly rated, liquid securities that the sponsor can access on short notice. AM Best also looks favorably on facilities that require put options to be exercised when certain events occur, such as a catastrophe loss (natural, man-made, or pandemic). These trigger events should be clearly defined. If the put option rests with the holding company, credit is given if the holding company is obligated contractually to downstream the funds to its insurance operating subsidiary. In cases where the put option involves a hybrid issuance at the operating company level, the maximum available credit would be based on the factors described in the **Financial Leverage** section, but could reach 100% if the facility involves the issuance of common equity securities. However, since limitations are placed on all forms of contingent capital, in cases where credit is given in the published BCAR model, the maximum credit allowance is 10% of total available capital. The credit allowance may be increased when viewed in

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stress scenarios. Also, where credit is given on a pro forma basis—that is, prior to exercising the put option—the securities to be issued pursuant to the contingent capital facility will count toward the financial leverage calculation.

Facilities that do not conform to these specifications (i.e., the SPV is not fully funded or triggering the facility is subject to management discretion) still can receive credit on a qualitative basis, and on a quantitative basis toward the stress-tested capital requirement. Here, the securities to be put to the SPV would not count toward the financial leverage calculation until actually issued.

Letters of credit from financially strong, reputable counterparties may also be given capital credit for certain business structures. When an LOC is drawn, it becomes capital for the insurance carrier and debt for the parent.

Other Common Adjustments to Reported Capital

Described below are some common adjustments which may be made in the BCAR calculation of available capital. Not all adjustments will need to be made, and adjustments will depend on accounting standards employed, type of business, and regulatory jurisdiction, among other circumstances.

When applying these adjustments, the analyst will take into account their significance to the company's total available capital. In those cases where BCAR is considered excessively reliant on additional adjustments—in addition to any caps to be applied to specific items—the assessment will consider the company's available capital position both prior and post adjustments.

Unearned Premium Equity

For accounting regimes which do not allow for deferred acquisition costs, in the case of unearned premiums, AM Best increases available capital accordingly - similar to that reflected in US GAAP financials. This equity adjustment allows AM Best to place a growing rating unit, which is penalized for heavy pre-paid acquisition costs, on a comparable basis with a mature rating unit, which has flat or declining acquisition costs.

For non-life insurers, if a rating unit's book of business generates a discounted accident year loss and LAE ratio in excess of 100%, AM Best does not recognize any equity in unearned premiums. For rating units with discounted accident year loss and LAE ratios below 100% but still higher than their pre-paid underwriting expense structure will allow, AM Best recognizes only a pro-rata share of the deferred acquisition costs as equity.

A risk charge is applied to the unearned premiums to reflect the pricing risk inherent in the rates charged for business written last year, but still unearned as of the current year-end, and the charge is subtracted from the unearned premium equity. This pricing risk is separate from the pricing risk associated with the business that will be written in the upcoming year. The model uses the current year written premium as a proxy for the upcoming year's writings.

For life contracts acquisition costs may similarly penalize an insurer's reported equity. AM Best will increase available capital accordingly to ensure insurers are assessed on a comparable basis. This may

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be considered as part of estimating the Net Economic Value due to Long-term Business (see subsequent section).

Loss Reserve Equity

AM Best adjusts available capital to reflect the net equity embedded in loss reserves. This equity represents the difference between a rating unit's economic reserves—which reflects AM Best's view of ultimate reserves on a discounted basis—and carried reserves.

Any reserve equity gain from reinsurance transactions already included in available capital is removed from available capital, since the equity will be awarded through the calculation of loss reserve equity. This is consistent with AM Best's treatment of statutory discounting and with efforts to treat loss reserve equity consistently. The best example of this is retroactive reinsurance through a loss portfolio transfer in which a rating unit often pays the reinsurer assets equal to the present value of the loss reserve portfolio plus a risk margin and then cedes the full value loss reserves, producing a gain that is embedded in reported capital. However, because of accounting procedures, these loss reserves remain on the primary insurer's books, and the ceded reserves are treated as a negative liability. Since the ceded reserves remain in the balance sheet reserves, some form of adjustment is needed. Otherwise, the time value of money would be credited twice—once in reported capital and once in the calculation of loss reserve equity. In this case, AM Best removes the gain from reported capital, and the equity in these reserves is awarded through the discount factor in the calculation of reserve equity. A reserve risk charge still applies to these reinsured losses. Without additional stop loss, the primary insurer remains exposed to potential adverse loss development on these reserves.

Market Value Adjustments

Where investments are not marked to market on the balance sheet, available capital can be adjusted to reflect a rating unit's securities' market value to allow for a better view of a rating unit's current economic capital position. Unrealized losses can be reviewed by the analyst to gauge whether the loss will become permanent, whether the underlying assets still are performing, and whether there is a near-term cash flow requirement and sufficient cash flow or liquidity to handle this need.

Equalization Reserves

Under some regulatory regimes, insurance companies must hold equalization reserves for particularly volatile lines of business. When equalization reserves are classified as liabilities, credit as available capital can be considered if there is strong evidence that these reserves are well in excess of actuarial best estimates. AM Best expects to review independent third party evaluations demonstrating a stable risk portfolio and a consistent track record of emerging profits. Consideration will be given to the potential lack of fungibility of the reserves in question and the significance of the book of business in question as part of the total insurance portfolio.

Surpluses in Funds with Discretionary Participation Features

Available capital could be adjusted to include surpluses identified in funds with discretionary participatory features. An example of this would be the Unallocated Divisible Surplus (UDS) reported

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for with-profits funds by European life insurance companies. The percentage of surpluses eligible as available capital will depend on the split applicable for distribution between policyholders and shareholders. Given their typical lack of fungibility, equity credit may be limited, though the limit would not normally be lower than the capital requirements that can be attributed to the particular fund generating these surpluses. Credit may be also limited if the rating unit's available capital is considered to depend excessively on this item or if the fund to which these surpluses are related to is not material in size compared to the total insurance liabilities.

Net Economic Value due to Long-term Business

Available capital may include partial equity credit for the net economic value due to particular blocks of long-term business. In order to receive equity credit for available capital purposes, the insurance portfolio in question should be considered stable, permanent, and with a track record of generating profits. Economic value amounts should be net of any elements that may have already been considered part of AM Best's total available capital assessment (e.g., Deferred Acquisition Costs or market value adjustments). The precise amounts should be derived from a reporting framework which is widely recognized by the market and has been subject to independent reviews. A typical example would be the balance sheet figures under Solvency II.

Given the sensitivity of economic values to market conditions, in most cases no more than 50% of the net calculated amount will be considered as available capital. Upwards adjustments may be possible in cases where there is a high likelihood of economic value being monetized (e.g., via securitizations, portfolio transfers or a record of enhanced financial flexibility). On the other hand, situations which may justify a lower amount of credit would include: lack of fungibility, a high dependence of total available capital on the net economic value adjustment, and volatility of reported figures.

Goodwill & Other Intangibles

Because assets such as goodwill and intangibles have no loss absorbing capacity, they are excluded from available capital.

Future Operating Losses

If forecasts are not carried out, a company's reported capital and surplus generally is reduced for operating losses, assuming that such losses would recur in the following year. However, given the cyclical nature of certain lines of business, AM Best recognizes that certain operations in the insurance company can support other business lines in different economic environments. Therefore, capital is reduced only if there is a net operating loss for the company in total, thus allowing gains in one line to offset losses in another. This assumes that sustained profitability and operating contributions to surplus are crucial components of long-term capital adequacy. Any reduction caused by operating losses can be modified by the analyst for one-time or nonrecurring items that affect operating results.

Fair Value of Own Debt

In some instances, a company's own debt is accounted for under fair value, which results in unrealized gains or losses reported in income and equity. In such cases, reported equity may be reduced by after-

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tax gains due to changes to the insurers' own credit risk. Unrealized gains occur as the fair value of the outstanding debt declines, which may indicate deterioration in an insurer's financial condition.

The BCAR Hybrid Capital Assessment

AM Best generally reviews an organization's risk-adjusted capital from both a rating unit perspective and a consolidated (or holding) company perspective, taking into account the adjustments noted above when appropriate.

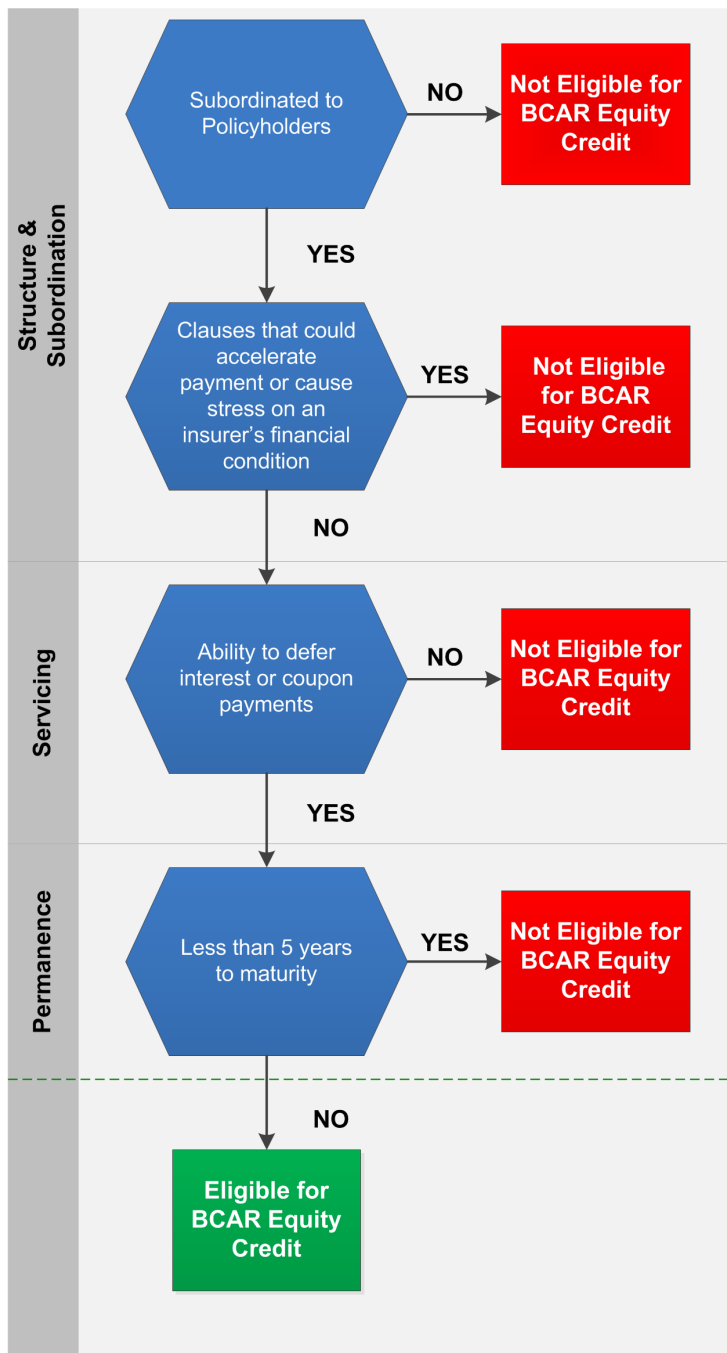
For hybrid debt that is part of the capital structure, **Exhibit C.2** provides a useful guide for what is considered when assessing eligibility for available capital for BCAR purposes. When reviewing a capital instrument for BCAR capital credit, the analyst will focus primarily on the security's permanence. In general, the longer the time remaining to maturity, the greater the equity credit granted. Considerations regarding the existence of call options, the likelihood of them being exercised and the company's history in respect of refinancing hybrid securities with similar instruments in the capital structure will be similar to those applicable for permanence purposes when calculating financial leverage.

Securities with 15 years or more remaining to maturity will be given full equity credit; credit for securities with less than 15 year remaining to maturity will be awarded based on the perceived permanence of such capital and management's history of replacing such securities with equivalent new issues. Generally, credit amortization is expected to be performed on a linear basis, giving a maximum equity credit of 100% at 15 years or more and a minimum of 1/3 of its par value at 5 years. Typically, remaining maturities of less than 5 years are not eligible for BCAR equity credit.

In general, the analyst is indifferent to the hybrid's structure and subordination as long as it is clearly subordinated to policyholders (if it is not subordinate to policyholders, it is not eligible for equity credit). Servicing costs are reflected in the evaluation of coverage, and typically do not affect the application of equity credit for BCAR. However, if there is an inability to defer payments, then BCAR equity credit is generally not afforded. Finally, for the hybrid securities to be considered for equity credit, AM Best expects that the primary regulator of the issuer will recognize the securities as qualifying regulatory capital.

When hybrids are considered eligible for BCAR available capital purposes, they may receive 100% equity credit up to a limit of 20% of total available capital.

Exhibit C.2: BCAR Hybrid Capital Assessment



Rating Unit Perspective

Many rating units do not directly issue debt; rather, funds are downstreamed from the holding companies that issue debt. Often this downstreamed contribution is in the form of cash subscribed as equity. In these cases, analysts will run two BCAR calculations.

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1. At the rating unit level: Credit is granted for all downstreamed cash contributed as capital (100% equity credit).
2. At the holding company/consolidated level: The capital instrument issued at the holding company goes through the process outlined in **Exhibit C.2**.

If hybrid debt is issued at the operating company, equity credit is subject to a 20% limit of the firm's total available capital for BCAR purposes (including any adjustments referred to in the previous sections). Debt at the rating unit level is viewed in accordance with the same guidelines in **Exhibit D.1**, to determine any impact on the balance sheet strength assessment.

Double Leverage

Double leverage is the ratio of an HC's investments in subsidiaries to the HC's adjusted own equity. Double leverage is measured to help determine the extent to which debt issued by the holding company is contributed as equity to one or more operating companies. A ratio higher than 100% indicates that the investment in subsidiaries has been funded with debt. High double leverage can lead to an unfavorable view of an organization's capital structure as it may reflect lower capital than is reported at the subsidiary level.

(Operating) Holding Company Perspective

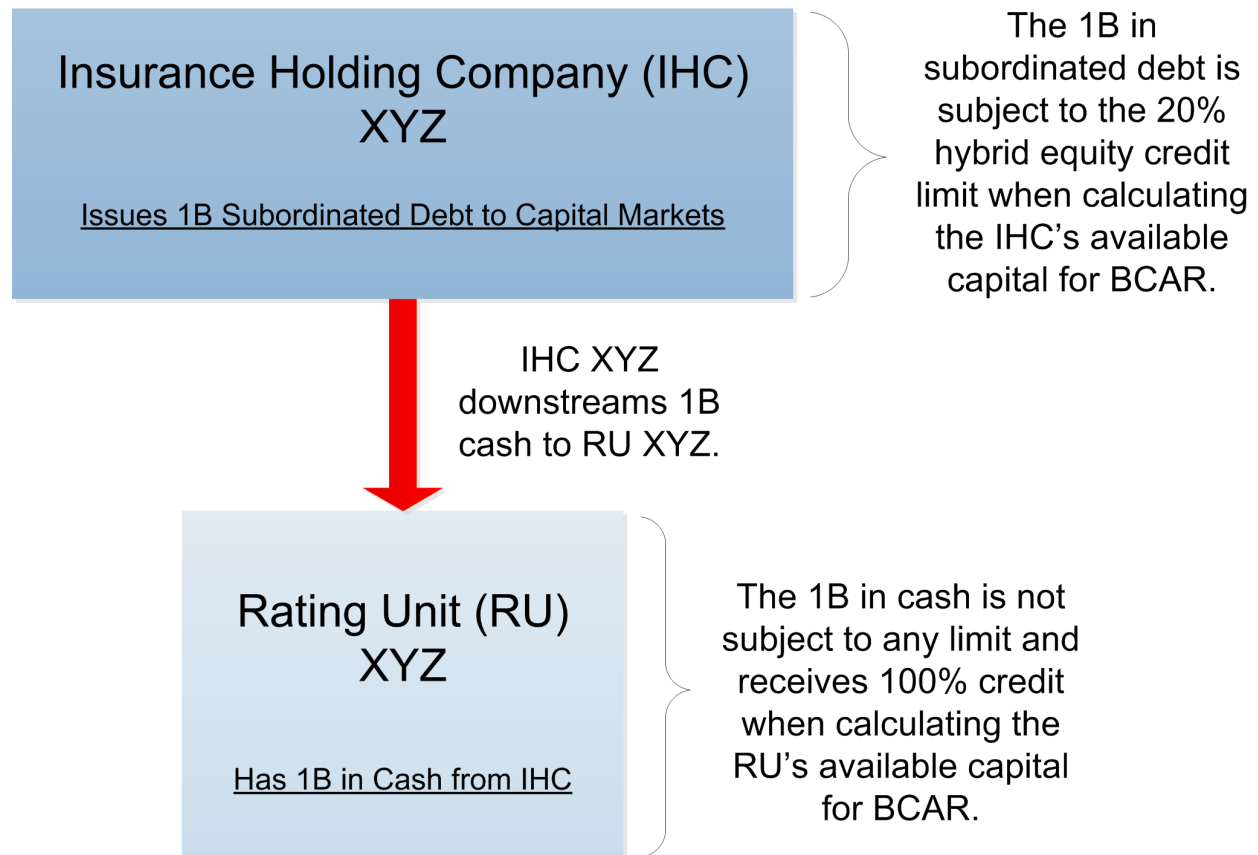
Insurance (operating) holding companies issue debt directly and thus debt may be included in their BCAR calculation as available capital, based on the process described in the discussion of financial leverage and in **Exhibit C.2**. This consolidated perspective offers an enterprise view of the risk of all rating units in the group.

When viewing debt from the consolidated perspective, understanding the flow of funds if capital movement is constrained due to regulatory restrictions is also relevant. In these cases, capital instruments that are outside the capital structure of the rated entity and have been identified by management as available for funding insurance operations may not be considered available capital for the insurance entity.

In one of the earlier financial leverage equity credit examples, Insurance Holding Company XYZ (IHC XYZ) issued USD 1B in subordinated debt. The company chose to downstream the USD 1B to its insurance rating unit, XYZ. For the rating unit's BCAR purposes, the USD 1B at the rating unit level is treated entirely as available capital (**Exhibit C.3**).

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Exhibit C.3: Downstreamed Capital in BCAR



However, for purposes of the consolidated BCAR, the USD 1B counts as capital up to the 20% limit on hybrid capital instruments. After issuance of the subordinated debt, IHC XYZ has USD 3B in reported equity and USD 1.5B in subordinated debt (it had USD 500M in subordinated debt prior to the USD 1B issuance). Therefore, its total balance sheet capital (before applying any limits) is USD 4.5B. Since IHC XYZ has exceeded the 20% cap for hybrid security issuance, only USD 750M (20% of 3.75B) of the hybrid issuance counts towards available capital for its BCAR calculation (**Exhibit C.4**).

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Exhibit C.4: BCAR Hybrid Capital Example - Insurance Holding Company XYZ (000s)

Capital Structure	Post Issuance Balance Sheet	BCAR Credit (20% Hybrid Limit)
Reported Equity	3,000,000	3,000,000
Other Equity Adjustments	0	0
Subordinated Debt	1,500,000	750,000
Capital	4,500,000*	3,750,000**
Ratio of Hybrid Debt to Total Capital	33%	20%

* Total Capital

** Available Capital

Note: Subordinated debt credit is limited to 20% of total capital. Therefore, only USD 750,000 (20% of USD 3,750,000) is available for the BCAR calculation of available capital.

Exhibit C.5 details the calculation of available capital for AAA, a consolidated group. AAA has USD 15B in reported equity. Other equity adjustments (3B) plus USD 8B of subordinated debt bring its total capital to USD 26B. However, due to the 20% limit on credit for subordinated debt, only USD 4.5B (20% of USD 22.5B) of its subordinated debt is considered available capital. Therefore, its total available capital for the BCAR calculation is USD 22.5B.

Exhibit C.5: BCAR Hybrid Capital Example - Consolidated Group AAA (000s)

Capital Structure	Post Hybrid Balance Sheet	BCAR Credit (20% Hybrid Limit)
Reported Equity	15,000,000	15,000,000
Other Equity Adjustments	3,000,000	3,000,000
Subordinated Debt	8,000,000	4,500,000
Capital	26,000,000*	22,500,000**
Ratio of Hybrid Debt to Total Capital	31%	20%

* Total Capital

** Available Capital

Note: Subordinated debt credit is limited to 20% of total available capital (as above). Therefore, only USD 4.5B of the subordinated debt total of USD 8B is considered to be available for the BCAR calculation of available capital. Other equity adjustments include the net total effect of a number of items, such as net economic value due to long-term business (positive) and goodwill (negative).

D. Insurance Holding Company Analysis

As part of a company's balance sheet strength assessment, insurance holding company (IHC) capitalization and liquidity is reviewed to determine if the holding company has a "positive," "neutral,"

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“negative” or “very negative” impact on the company. In addition to the view of risk-adjusted capitalization, **Exhibit D.1** focuses on additional financial assessments that are part of the holding company evaluation. The key characteristics described below for each assessment category are not intended to be prescriptive, but to provide additional guidance beyond what is described in the BCMR.

Exhibit D.1: Holding Company Financial Assessment

	Very Negative	Negative	Neutral	Positive
Capital Assessment	• Poor financial flexibility • Weak quality of capital • High leverage in capital structure • Adjusted leverage > 65%	• Limited financial flexibility • Reliance on soft capital • High double and/or operating leverage • Adjusted leverage 45% to 65%	• Demonstrated financial flexibility • Moderate overall leverage • Limited impact from operating leverage • Adjusted leverage < 45%	• Proven access to capital markets even during times of stress • High quality capital structure • Low levels of soft capital & intangibles • Adjusted leverage < 25%
Liquidity	• Poor liquidity management • Limited to no access to external liquidity sources	• Elevated near term claims on cash • Access to external liquidity sources questionable	• Laddered maturity schedule • Alternative liquidity readily available	• Laddered maturity schedule • Strong liquidity management
Coverage	• Weak coverage < 2x	• Low coverage 2-3x	• Adequate coverage > 4x	• Strong coverage > 7x

The characteristics described for each category are ideal scenarios and are not intended to be prescriptive.

For example, an IHC may provide enhancement to a lead rating unit’s balance sheet strength assessment if an IHC maintains significant liquid assets, and these funds are available to meet its ongoing insurance obligations. Similarly, if an IHC maintains weak leverage or coverage measures, this will be factored into the lead rating unit’s balance sheet assessment. As discussed in the following section, an analysis of liquidity is an integral part of the IHC assessment.

In cases where the rating unit itself (or one of its members) is the one issuing debt, as opposed to a holding company, the same guidelines apply when assessing balance sheet strength.

Insurance Holding Company Liquidity

Liquidity depends on the degree to which financial obligations can be satisfied through operating cash flow or from holding company cash and investments that are sound and diversified. As the key source of holding company liquidity is generally the dividends received from owned insurance operating companies, the presence of profitable, nonregulated entities may be viewed favorably. Understanding potential liquidity stresses is an important part of the holding company assessment.

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AM Best analysts review current and projected sources and uses of cash for a holding company, to judge the sustainability of current and future sources of funds and the holding company's access to any alternative funding. This process may include reviews of any guarantees made by the holding company on behalf of its subsidiaries. In addition, analysts review the certainty of cash uses such as fixed charges, shareholder dividends and maturing debt.

Most holding companies first rely on their own internal funding sources, which include any cash and securities maintained at the holding company level. This generally is supplemented by dividends received from owned operating subsidiaries. However, by virtue of being regulated, there are usually restrictions on dividends paid to the parent holding company from insurance operating subsidiaries. Most jurisdictions have restrictions for regulated insurance operating companies with respect to availability of dividends, though the overall effect of these can vary considerably depending on the regulatory framework.

AM Best believes holding companies that maintain cash buffers are in a better credit position to absorb lower potential future dividends from insurance operating companies if adverse situations arise.

Analysis of Sources and Uses

Sources and uses change over time. In times of financial crisis, many external funding sources can dry up and become unavailable even for highly rated entities. Additionally, a company's maturing debt may not be well 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 also incorporate a strategy for handling stress scenarios. Liquidity is the first line of defense against adverse pressures from either internal or external forces.

Elements of the Analysis

Ideally, an IHC has access to funds to meet its expected obligations, has an additional buffer to cover potential unknown stresses, and limits its reliance on insurance operating company dividends. An issuer's liquidity profile should be considered in the context of immediacy, quality, and diversity. The following list depicts some elements that may be incorporated into AM Best's liquidity analysis:

- Management's philosophy with regard to liquidity, financial flexibility, and how short-term borrowings fit into the insurer's overall funding strategies
- The minimum required cash position (with buffer) to meet short-term liabilities
- Operating cash flow, including premiums from in-force business and the degree of volatility in operations
- Short-term sources of financing available to the issuer (including the availability within regulatory constraints of dividends or other transfers from subsidiaries) and short-term funding arrangements such as commercial paper programs
- The degree of dependence on the various sources of liquidity

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- The loyalty and financial strength of banking relationships and other backup arrangements
- Cash and/or cash equivalents held at the holding company
- The company's current and prospective interest coverage ratios, to evaluate earnings coverage
- Overall financial leverage and the ability to repay current liabilities
- The company's dependence on operating leverage and the ability to liquidate assets to repay "matched" obligations
- Stress scenarios and contingency plans should external funding suddenly become unavailable

Sources of Liquidity

IHCs have internal and external sources of liquidity. In general, the most reliable source of liquidity is internally generated sources of funding. Sources of liquidity may include the following:

- Cash on hand
- Near-term cash resources, including the ability to transfer funds from subsidiaries
- Commercial paper
- Bank credit facilities
- Letters of credit (LOCs)
- Federal home loan bank borrowings

Uses of Liquidity

The general uses of liquidity for an IHC are retiring direct obligations such as short-term borrowings or maturing long-term borrowings, other debt service obligations and paying common or ordinary shareholder dividends. In addition, liquidity normally is necessary to fund working capital needs and to cover operating expenses. Finally, a return to investors may be provided from 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, which may include 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. AM Best may also factor in management's track record of reducing discretionary cash outflows in periods of increasing financial stress.

Additionally, if the IHC 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)

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- Short-term debt
- Current portion of long-term debt
- Contingent obligations
- Funding arrangements (including the use of reverse repos) if done at the holding company level
- 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., some 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 (including 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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