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Additional Information**Criteria:**

Insurance Holding Company and Debt Ratings

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A.M. Best's Perspective On Operating Leverage

In forming an overall opinion of a company's balance sheet strength – the most important area in determining a company's ability to meet its current and ongoing obligations to policyholders – A.M. Best Co. reviews the organization's total leverage, which includes financial leverage and operating leverage. Financial leverage, through debt or debt-like instruments, may place a call on an insurer's earnings and strain its cash flow. Also, excessive leverage at the operating or holding company can lead to financial instability.

Operating leverage is broadly defined as leverage utilized in normal business operations (insurance or non-insurance) to support liquidity or to provide additional sources of operating income with tight duration or cash-flow matching characteristics. These activities 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. Regardless of its form, leverage may impact an insurer's liquidity, cash flow and operating profile and could lead to financial instability, particularly during times of systemic capital market distress.

Generally, the debt portion of an insurer's capital structure is utilized as working capital for its insurance lines. For organizations with debt-issuing holding companies, dividends from the insurance subsidiaries typically represent a major source of debt service. Diversified enterprises that possess 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 eligibility requirements outlined on the following pages, A.M. 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. However, for organizations with highly leveraged non-insurance operations, A.M. Best will consider extraordinary (i.e., wider) notching of debt securities issued by holding companies as well as the potential impact on the insurance company's ratings.

For organizations that issue debt or debt-like instruments directly from an operating insurance company, amounts eligible for operating leverage treatment generally would involve cases where residual risk to the insurer is insignificant. Because financial instruments may be issued either by holding companies or by operating companies (or by both), A.M. Best will apply specific tolerances at each operating company, as well as on a consolidated basis. If the tolerance is exceeded at an individual operating company or in aggregate, A.M. Best would monitor closely the issuer's appetite for additional forms of leverage (for example, retail notes and/or institutional spread-based [ISB] products) and would contemplate lowering the entity's rating if growth trends vary substantially from previous expectations.

This criteria report can be found at
www.ambest.com/ratings/methodology



(Please see **Step 1** on page 5 for operating company examples.) Ultimately, debt obligations viewed by A.M. Best as operating leverage would be excluded fully from the calculation of consolidated financial leverage, unless the tolerance level is exceeded. (Please refer to **Step 2** for a consolidated view.)

Eligibility for Operating Leverage Credit

A.M. 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 with the obligations. Additionally, the insurer must possess 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. Some examples of activities that typically would be viewed as operating leverage include:

- Securities lending programs
- Repurchase and reverse repurchase agreements (repos)
- 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 utilized by property/casualty insurers
- Letters of credit (LOCs), debt or parental guarantees related to Regulation XXX or Guideline AXXX (XXX or AXXX) securitizations
- Term Asset-Backed Loan Facilities (TALF) or similar future government programs that introduce leverage to an insurer's balance sheet
- Other off-balance-sheet liabilities

Given that capital market financing solutions will continue to evolve, this listing is not meant to be exhaustive, and A.M. Best reserves the right to interpret new forms of capital market financing as operating or financial leverage based on its assessment of their underlying, fundamental characteristics.

With respect to closed-block monetizations, A.M. Best would tend not to view the debt associated with these transactions as operating leverage, particularly if the debt is with recourse. A.M. 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 on an organization's business profile of eliminating the closed block's future earnings and deploying the debt proceeds in higher risk, higher return businesses will be incorporated in the overall financial strength evaluation. However, A.M. Best's tolerance for financial leverage for that company likely would increase, depending on the characteristics of the in-force block.

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. The recent financial crisis highlighted potential areas of credit risk associated with insurers' investment of cash collateral received from securities lending transactions that subsequently deteriorated in value, resulting in additional credit risk from a presumed "low-risk" activity. Given that the industry has reduced the scope and complexity of these programs while enhancing risk management governance practices, A.M. Best will continue to permit operating leverage treatment. However, should an insurer demonstrate over-reliance on securities lending or have a track record of incurring collateral-related losses, A.M. Best may disallow full 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 compa-

nies that invest the loan proceeds in their core businesses for working capital, these obligations would be viewed as financial leverage. However, more recently, insurers have utilized these borrowings to enhance investment yields and as a potential liquidity source. If FHLB borrowings are being utilized for spread enhancement activities (i.e., similar to securities lending in purpose) and the insurer can demonstrate strong asset/liability and liquidity management expertise, A.M. 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 GLCs (general account, separate account and synthetic), funding agreements, FABS and retail notes. However, if FHLB programs are being used as a liquidity or capital backstop, A.M. Best would view such borrowings as financial leverage, particularly longer term FHLB borrowings that are not being match-funded.

Another type of debt obligation that A.M. 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 utilized senior unsecured debt issuances to self-fund XXX and AXXX reserves. In this case, only debt issued by the holding company will be afforded 100% 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 full operating leverage credit.

In recent years, XXX and AXXX funding solutions have been utilizing 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. A.M.

Best will only consider full operating leverage treatment 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. More recently, some regulators are permitting the utilization of holding company guarantees to XXX and AXXX captives in lieu of external financing. In these instances, A.M. Best will qualitatively incorporate these holding company guarantees as part of its operating leverage tolerance.

The Term Asset-Backed Securities Loan Facility (TALF) program was implemented during the financial crisis and is currently in runoff. The TALF program was nonrecourse to the borrower, with funds provided by the Federal Reserve to purchase asset-backed securities. These collateralized securities could be delivered back to the Federal Reserve's special-purpose vehicle in full defeasance of the loan; therefore, credit risk was not material absent a modest amount of capital initially contributed by the insurer. Given these characteristics, A.M. Best would tend to view these facilities, or future government-sponsored facilities with similar terms, as operating leverage.

Other Considerations

A.M. Best will employ a "look-through approach" for off-balance-sheet liabilities as disclosed in the financial statement footnotes in its calculation of operating leverage tolerance. Specific examples could include the speculative selling of naked CDS on corporate debt obligations by a holding company. Although these transactions are not widely utilized by insurers, these types of speculative transactions will be reviewed and considered on a qualitative basis. The purpose of this review is to look only at speculative-type CDS transactions and exclude bonafide CDS transactions utilized for investment management or enterprise risk management purposes. These types of transactions could also include the purchase of credit default swaps on fixed-income investments to mitigate credit risk or the sale of a CDS as part of an insurer's replicated investment strategy (i.e., to obtain credit exposure to an issuer not available in the cash market).

Another type of off-balance-sheet liability can arise from variable interest entities (VIEs),

which are utilized for investment and asset management purposes. VIEs may or may not be consolidated on an insurer's balance sheet, depending upon 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). Similar to speculative CDS, VIEs on an insurer's balance sheet will be reviewed qualitatively in an assessment of an insurer's operating leverage. 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 risk of loss is limited to the insurer's investment in the VIE.

Accordingly, A.M. Best typically would view financings resulting from the aforementioned activities as operating leverage if the insurer possesses 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. For financings to receive operating leverage treatment in the financial leverage ratio calculation, A.M. Best must be able to (1) analyze the assets supporting these debt issuances, (2) understand management controls and the structure of the funding mechanism and (3) review specific provisions related to debt covenants. Moreover, A.M. 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

A.M. Best views operating leverage-related activities as reasonable for highly rated 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 certain situations such as a rating downgrade or a contract containing

negative covenants or adverse put options. Given the sizable amount of deleveraging that has taken place since the financial crisis, A.M. Best expects consolidated and operating company leverage to be maintained at reasonable levels that reflect current capital market conditions. With respect to insurance operating company leverage, A.M. Best is most comfortable when operating leverage activities such as institutional investment products and spread lending do not constitute a large proportion of general-account liabilities.

A.M. Best has developed specific guidelines for each rated statutory insurance operating company of a group and all statutory insurance operating companies combined (statutory view; see **Step 1**). In short, A.M. Best would be uncomfortable with a statutory entity or group if the sum of ISB product liabilities, retail notes outstanding, liability for securities lending and FHLB loans exceeds 50% of general account "reserves" (defined here as lines 1 through 6.3 of the Life/Health Annual Statement). As mentioned previously, A.M. Best would monitor closely the issuer's appetite for these products and contemplate lowering the entity's ratings if growth trends vary substantially from previous expectations.

A.M. Best also will perform a test at the consolidated holding company level (GAAP basis; see **Step 2**) to determine the full impact of operating leverage treatment on an organization's published debt-to-capital ratio. Credit for operating leverage will be reduced if the sum of activities qualifying for operating leverage (see above examples) exceeds 30% of consolidated (GAAP) 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 A.M. Best's debt-to-capital calculations.

Finally, for analytical purposes, A.M. Best will consider the impact of this analysis on the organization's interest coverage ratios.

Operating Leverage Definitions and Examples

STEP 1

Example 1 - ABC Insurance Co.:

Product	Amt. O/S (\$ Millions)
GICs	-
FABS	-
FAs	3,600
Retail Notes	-
Securities Lending	1,000*
FHLB Borrowings	800
Total OCB	5,400
General Account (GA) Reserves (Annual Statement lines 1-6.3)	9,000
OCB/GA Reserves	60%

This exceeds A.M. Best's 50% tolerance for a statutory entity. Hence, A.M. Best would closely monitor the company's appetite for these products and contemplate lowering the issuer's stand-alone rating if growth trends vary from A.M. Best's expectations.

Example 2 - XYZ Insurance Co.:

Product	Amt. O/S (\$ Millions)
GICs	400
FABS	1,400
FAs	200
Retail Notes	-
Securities Lending	950
FHLB Borrowings	650
Total OCB	3,600
General Account (GA) Reserves (Annual Statement lines 1-6.3)	10,000
OCB/GA Reserves	36%

This does not exceed A.M. Best's 50% tolerance for statutory entities.

Operating Company Borrowings (OCB) = GICs, FABS, funding agreements (FAs), retail notes, securities lending and FHLB advances

Total Balance Sheet Leverage = Consolidated balance sheet debt-to-capital ratio (unadjusted)

Financial Leverage = Debt-to-capital ratio assuming full operating leverage credit

Total Operating Borrowings = Operating company + Holding company operating borrowings (i.e. Operating Corporate Debt)

Composition Ratio = Total Operating Borrowings/Consolidated GAAP liabilities less separate-account liabilities

Adjusted Financial Leverage Ratio = Ratio that reflects the financial leverage + any operating leverage amounts exceeding the holding company tolerance

STEP 2

Example 1 - ABC Holding Co., Inc.:

Balance Sheet Item	Amt. (\$ Millions)	
Short-Term Debt	600	
Long-Term Debt	1,500	
Oper. Corp. Debt	1,000*	
Total Debt	3,100	
Total Equity	7,900	
Total Capital	11,000	
Total GAAP Liabilities	25,000	
Total OCB	5,400	
Total Operating Borrowings	6,400	(5,400 + 1,000)
Total Balance Sheet Leverage	28%	(3,100/11,000)
Financial Leverage	21%	(3,100-1,000)/ (11,000-1,000)
Composition Ratio	26%	(< 30%)
Tolerance	7,500	(.30)(25,000)
Amount Exceeding Tolerance	-	(6,400-7,500)
Adjusted Financial Leverage	21%	(3,100-1,000)/ (11,000-1,000)

For analytical purposes, this group's financial leverage ratio will reflect full credit for \$1 billion in operating leverage (*)

Example 2 - XYZ Holding Co., Inc.:

Balance Sheet Item	Amt. (\$ Millions)	
Short-Term Debt	600	
Long-Term Debt	1,500	
Oper. Corp. Debt	2,300**	
Total Debt	4,400	
Total Equity	5,600	
Total Capital	10,000	
Total GAAP Liabilities	15,000	
Total OCB	3,600	
Total Operating Borrowings	5,900	(3,600 + 2,300)
Total Balance Sheet Leverage	44%	(4,400/10,000)
Financial Leverage	27%	(4,400-2,300)/ (10,000-2,300)
Composition Ratio	39%	(> 30%)
Tolerance	4,500	(.30)(15,000)
Amount Exceeding Tolerance	1,400	(5,900-4,500)
Adjusted Financial Leverage	38%	(4,400-2,300+1,400)/ (10,000-2,300+1,400)

For analytical purposes, this group's financial leverage ratio will reflect partial credit (\$0.9 billion) for its \$2.3 billion in operating leverage (**)

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Methodology

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