A.M. BEST

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The Treatment of Surplus Notes and Trust-Preferred Securities in the Financial Strength Ratings of Insurance Companies

Surplus notes aren't newcomers to the insurance industry. In fact, they have been in circulation for more than a decade.

In the 1990s, most surplus notes were issued for relatively small sums and short durations. Only the largest companies in the industry could afford to issue large denominations with far-reaching terms to maturity. In this environment, using surplus notes to improve long-term capital wasn't particularly effective, and thus small to midsize mutual companies were extremely limited in their ability to strengthen their balance sheets through external sources.

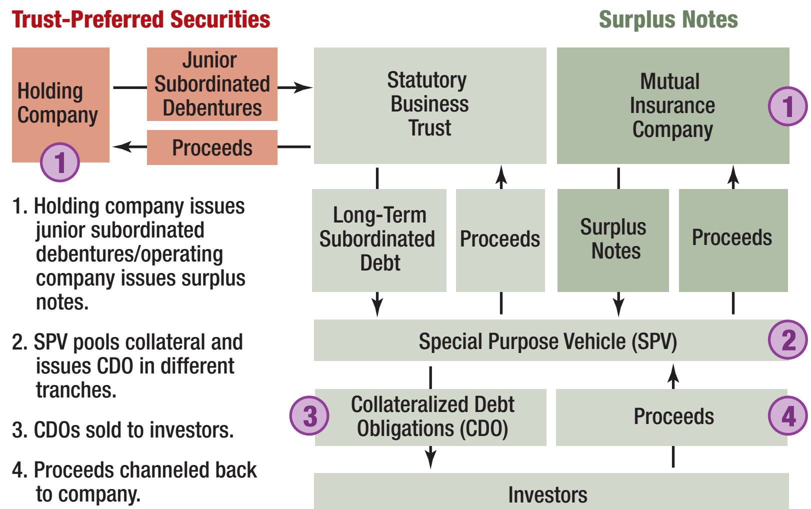
This limited access to capital wasn't unique to mutual insurance companies. Small, privately held stock companies also were denied access to the capital markets. Capital-raising initiatives often revealed that stockholders were reluctant to dilute their ownership interest, and investors generally were unwilling to loan money to a privately held company in a heavily regulated industry with often uncertain or volatile earnings. For the small to midsize stock company, the market for its common equity or trust-preferred securities was almost nonexistent.

Enter the surplus note and trust-preferred securitization transactions (i.e. pools) of 2002. These transactions offer small and medium-size insurance companies the opportunity to access the public bond market and raise funds at favorable rates. The recent pools consist of surplus notes and trust-preferreds issued by 30 to 40 insurance organizations.

Collateralized notes are issued through a special-purpose vehicle and are backed by the subordinated debentures (i.e. the special-purpose vehicle's liabilities) of the insurance organization. These collateralized debt obligations generally are issued in three to four tranches and marketed to private and institutional investors. The pools hold roughly $300 million to $500 million in collateral, with no single issuer accounting for more than a 5% share of the pool. This limitation avoids a concentration of risk that could exacerbate the probability of default on the collateralized debt obligation. Even considering this limitation, issuing companies that qualify for the pool are able to obtain as much as $20 million in capital. A.M. Best Co.'s structured finance division analyzes the collateralized debt obligation itself and rates the various tranches of the pool based on its proprietary insurance company impairment and interest-deferral statistics.

Surplus Note and Trust-Preferred Analysis

The terms and conditions of the typical pool are considered favorable by A.M. Best. For one, the 30-year term to maturity enables the issuing company to enhance its surplus position over the long term. In addition, many of the current pools offer a repayment option



This special report was prepared by Stefan Holzberger, managing senior financial analyst, in the property/casualty division of A.M. Best Co.

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Example of Surplus Note/Trust-Preferred Pool Terms & Conditions

- **Collateral Issuers**: Property/casualty and life insurance companies.
- **Instrument**: Surplus notes and trust-preferred securities.
- **Amount**: Maximum issuance per company is less than 5% of pool; range of $2 million to $20 million.
- **Interest Rate**: Floating rate of three month LIBOR plus 350 to 450 basis points; fixed rate available for first five years.
- **Maturity**: 30 years
- **Cost**: 3% of amount issued plus $1,000 to $3,000 annual administrative expense.

after the fifth year, through which a company can retire its notes or trust-preferreds without penalty. This grants the insurance company the flexibility of employing the capital for short-, medium- or long-term objectives.

A second, and very important, characteristic of the current pools is the favorable interest rate offered. The cost of capital to the insurance companies for most pools is the three month London Interbank Offered Rate plus 300 to 400 basis points. This equates to an interest rate of between 4.15% and 5.15% as of the time of publishing. In many cases, the insurance company in the pool can lock in a fixed rate for the first five years. Given that the funds are unsecured, are generally junior to any other debt in the insurance company's capital structure and have favorable covenants, such as a prepayment option, A.M. Best considers the terms to be competitive and generally more flexible than a typical bank loan.

In the regulatory context, full equity credit is given to surplus notes and trust-preferred securities. In exchange, the regulators must approve the surplus note before its issuance. The state insurance department also maintains the right to deny any quarterly payment of interest or principal. As for trust-preferred securities, beyond the ordinary allowable dividend, regulators also have control over an insurer's ability to dividend large sums to the parent corporation for the purpose of meeting debt-servicing requirements.

A.M. Best takes a more conservative approach in its evaluation of these financial instruments and applies equity credit for surplus notes and trust-preferreds on a case-by-case basis. The individual evaluation—based on factors discussed below—determines how much, if any, equity credit will be given.

The first step in this process is to evaluate the specific terms and conditions of the surplus note or trust-preferred contract. A.M. Best starts with a quantitative approach to evaluating the characteristics of the issuance. For example, the cost of capital is weighed against the company's historic and prospective returns on equity. The principal amortization schedule is evaluated in the context of the permanency of the capital infusion. It should be noted that the current pools don't contain principal amortization schedules and instead require a balloon repayment of principal in the final year. A.M. Best looks upon the long-term nature of these pools favorably in its evaluation of an insurer's capitalization.

In addition to the above characteristics, A.M. Best considers the tail of the insurer's book of business in its evaluation. Since all financial strength ratings issued by A.M. Best address the ability of the organization to meet its financial obligations, the evaluation of a surplus note or trust-preferred security attempts to determine what effect the obligation will have on surplus over the period during which the organization's obligations, primarily claims, are outstanding. Thus, if the company

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writes small commercial accounts, for example, with a 95% coverage obligation (i.e. loss development tail) of five years, A.M. Best will determine the equity credit to be given in year one based on the cumulative cash flows of the note over a five-year duration. In a sense, A.M. Best relates the equity credit given to the company's expected duration of liabilities. Based on these factors, a baseline for determining equity credit is reached.

Once the preliminary evaluation is complete, the next step is to determine whether or not the company's performance and its overall capitalization increase or decrease equity credit. A.M. Best employs the commonly associated financial leverage and cash cover measures to determine whether or not the baseline equity credit should increase or decrease. Naturally, a company with high debt-servicing requirements will receive reduced equity credit based on the earnings drag associated with the interest obligation. And similarly, if a company's operating cash flows are deficient to the point where long-term investments need to be liquidated to honor short-term financial obligations, equity credit for surplus notes and trust-preferreds will be reduced.

Conversely, if an insurer's performance illustrates consistent earnings and favorable cash flows, and A.M. Best determines that the interest obligation won't have a material drag on accumulation of surplus, additional equity credit may be afforded. The company's access to emergency funds via a line of credit or parent organization also is relevant, particularly with regard to companies writing volatile classes of business, or books of business that are concentrated in catastrophe-prone areas. These companies are exposed to volatile earnings and cash flows that, without appropriate access to liquid assets, could result in sudden erosion of surplus and the inability to honor financial obligations.

Finally, on the qualitative side, A.M. Best looks at the intended use of the funds in its evaluation of the surplus note or trust-preferred security. Using the funds to replace lost surplus, without taking the necessary steps to repair a troubled book of business, won't improve policyholder security, and therefore a reduction of equity credit will be applied. The rationale for this is that although capital has improved in the short term, the inherent defects in the book of business, unless addressed, will continue to deteriorate the surplus position over time. With the added interest obligation, a company could soon find itself in a worse financial condition.

In contrast, a company that issues surplus notes or trust-preferred securities to fund profitable growth while maintaining conservative underwriting leverage can expect favorable treatment in A.M. Best's capital model. Also, utilizing the funds to reduce dependence on reinsurance is considered a viable option—assuming the insurer has the financial strength to cover the additional catastrophe or loss-frequency exposure.

Application of Equity Credit in A.M. Best's Capital Model

Once the evaluation is complete and equity credit is determined, the necessary adjustment is made to A.M. Best's Capital Adequacy Ratio (BCAR)—A.M. Best's proprietary capital model. The baseline BCAR is set up to give zero equity credit for surplus notes, so the adjustment involves reducing a portion of the risk charge commensurate with the intended equity credit. As for trust-preferred securities, since the funds are downstreamed from a holding company, the reported surplus is reduced by the value of the reduction in equity credit.

Generally speaking, the new generation of surplus notes and trust-preferred products are considered by A.M. Best to be a viable source of funds for small to midsize insurance organizations. It's important to keep in mind that equity credit is evaluated on a case-by-case basis. The stated cap on equity credit is 20% of statutory surplus. This limit, however, will depend on various factors such as the company's profitability, cash flows and liquidity, financial leverage, and overall capitalization. A.M. Best encourages companies to contact their analyst and discuss the potential impact a surplus note or trust-preferred issuance would have on its financial strength rating.

Finally, A.M. Best recognizes that during the life of a 30-year surplus note or trust-preferred security, a company's performance, capitalization or business profile can change dramatically. The analysis, therefore, is conducted on an annual basis together with the financial strength rating, and regular adjustments are made to equity credit, based on the company's performance. If earnings or capitalization decline, a reduction of equity credit could follow. Importantly, as the matu-

rity date of the financial instrument approaches, A.M. Best will require a plan that illustrates how the obligation will be satisfied—either through refinancing or repayment. A.M. Best is mindful of the fact that ultimately, both surplus notes and trust-preferreds are debt instruments that carry with them an expectation of repayment.

The Insurance Information Source

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A.M. Best Company
Ambest Road
Oldwick, New Jersey 08858
Phone: (908) 439-2200
Fax: (908) 439-3296
http://www.ambest.com

A.M. Best Europe Ltd.
1 Minster Court, 11th Floor
Mincing Lane
London, England EC3R 7AA
Phone: 011-44-207-626-6264
Fax: 011-44-207-626-6265
www.ambest.com.uk

A.M. Best International Ltd.
A.M. Best House
264 Northfield Avenue
London, England W5 4UB
Phone: 011-44-208-579-1091
Fax: 011-44-208-566-1789
www.ambest.com.uk

A.M. Best Asia-Pacific Ltd.
907, 9/F Shui On Centre
6-8 Harbour Road
Wanchai, Hong Kong
Phone: 011-852-2824-1107 Fax: 011-852-2824-1833
www.ambest.com.hk