

## Regulatory Review

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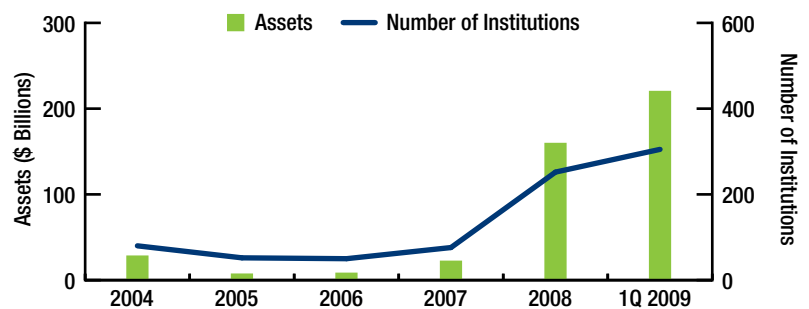
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## Regulatory Rules' Overhaul Seeks To Change Banking Landscape

The Obama administration's proposed overhaul of financial regulation sets an ambitious agenda that includes eliminating the thrift charter; creating a separate, federal consumer protection agency for financial services and products, and broadening oversight of institutions deemed "too big to fail." The plan, unveiled in June, sparked debate among members of Congress, regulators and industry groups, but little legislation is expected until after the congressional recess in August.

- The administration's plan would merge the Office of Thrift Supervision and the Office of the Comptroller of the Currency into a new National Bank Supervisor for all federally chartered banks.
- The Federal Reserve and Federal Deposit Insurance Corp. (FDIC) would keep their roles in regulating state-chartered banks.
- The Fed would have consolidated and supervisory authority over systemically important institutions deemed "too big to fail." An advisory council of regulators would help the Fed to identify systemic risks in the economy and financial system.
- Some regulators and market observers oppose expanding the Fed's powers, saying the advisory council should have greater authority to address systemic risks.
- The administration's plan also calls for broader regulatory mechanisms to ensure orderly resolutions of systemically important financial institutions should they fail.
- A new Consumer Financial Protection Agency would oversee existing financial services and fair-lending laws. Banking trade groups oppose a new, consumer-oriented agency that is separate from enforcement of an institution's safety and soundness.
- Systemic risk also is addressed through legislation that would change how the FDIC calculates and charges premiums for its deposit insurance fund.

### U.S. Banking – Problem Institutions (2004-1Q 2009)



Source: Federal Deposit Insurance Corp.

## Redrawing the Regulatory Map

The nation’s banks and key financial markets would undergo sweeping changes if elements of the Obama administration’s financial regulatory reform proposal ultimately become law. The president and Treasury Department launched the regulatory reform plan in late June, and Congress has been holding hearings throughout July on some of its provisions.

Depending on what Congress enacts, the administration’s regulatory response to the global financial crisis could represent the most broad-based transformation of the nation’s patchwork of financial regulation since the Great Depression. Among the more controversial of the proposal’s supervisory and regulatory reforms is the elimination of the federal thrift charter and the Office of Thrift Supervision (OTS) – the regulator that has overseen the thrift industry since 1989.

The proposal’s broader focus is on closing what the administration identifies as “gaps” and “loopholes” in the regulatory supervision of financial institutions and of markets for securitization and over-the-counter derivatives, among other things. Consumer protections from fraud and abusive practices would be strengthened through a new agency.

Meanwhile, institutions deemed “too big to fail” and systemically important potentially

could be overseen by the Federal Reserve, with further oversight from an advisory council made up of a broad coalition of regulators. The proposal also calls for mechanisms to wind down these large, interconnected financial institutions through a more orderly process should they fail.

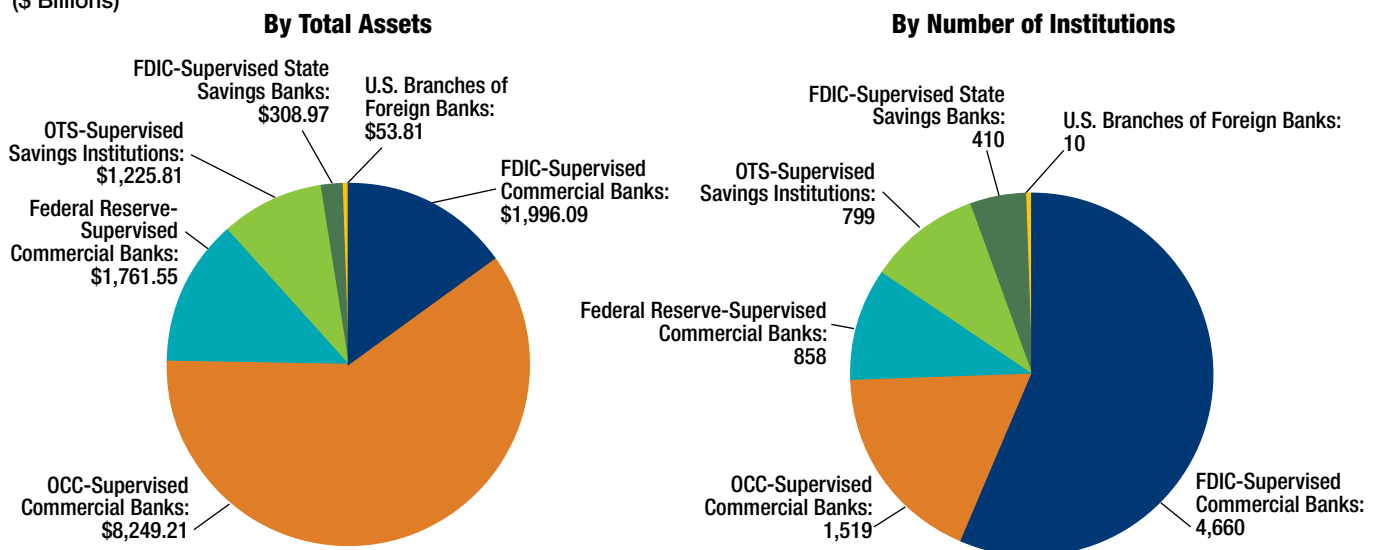
### New Boss for Banks?

As mentioned above, the proposal calls for the OTS to be merged with the Office of the Comptroller of the Currency (OCC) into a new National Bank Supervisor responsible for regulating all federally chartered banks. Thrifts, industrial loan companies, credit card banks – such as those associated with retailers – and trust companies would have to become bank holding companies (BHCs).

The proposal would preserve the roles of the Federal Reserve and the Federal Deposit Insurance Corp. (FDIC) in the regulation of state-chartered banks. The National Credit Union Administration also would continue to have oversight of federal credit unions.

Eliminating the thrift charter would do away with a banking sector that has been around since 1933 to serve the residential mortgage market. Through March 2009, 799 institutions with \$1.22 trillion of total assets were under OTS supervision, according to the FDIC (see **Exhibit 1**).

**Exhibit 1**  
**U.S. Banking — FDIC-Insured Institutions**  
(\$ Billions)



Source: Federal Deposit Insurance Corp.

The Obama administration argues that the need for a special class of “mortgage-focused” depository institutions such as thrifts has fallen with commercial banks’ increased appetite for mortgage lending – aided by securitization – and the expanded membership of the Federal Home Loan Bank System. Since thrifts are required to focus more of their lending on residential mortgages, they were more vulnerable to the housing downturn, the administration’s proposal says.

But the administration’s main concern is that the differences between supervision and regulation of BHCs and thrifts have created “material arbitrage opportunities.” The Federal Reserve, for example, imposes leverage and risk-based capital requirements for BHCs, while the OTS does not impose any capital requirements on thrift holding companies, the proposal says.

The American Bankers Association (ABA) and the Independent Community Bankers Association (ICBA), two industry trade groups, counter that the government should preserve the thrift designation, not punish a sector of the industry that has maintained sound, community-based mortgage underwriting. Most subprime and exotic mortgages were originated by non-banks able to skirt federal and state regulation, they say.

Eliminating the thrift charter likely also would affect other types of banks such as mutual savings institutions and state-chartered savings banks, as they currently may be regulated by the OTS. The IBCA notes the hardship existing mutuals organized as federal thrifts would face in being forced to convert to commercial bank charters. This, in turn, could force some mutuals to become stockholder-based companies, denying these institutions the option of mutuality.

While the administration’s proposal would eliminate the thrift charter, the interstate branching rules that thrifts currently enjoy would be preserved and even applied to state and national banks. The administration wants to lift restrictions that states might have on interstate branching that allow banks to enter other states only through acquisitions of existing banks.

“Permitting banks to expand across state lines improves their geographical diversification and, consequently, their resilience in the face of local economic shocks,” the proposal says.

### **Broader Federal Reserve Powers?**

The Obama administration’s regulatory reform proposal also would confer new powers on the Federal Reserve. The nation’s central bank, which primarily focuses on monetary policy but also oversees many aspects of the banking system, would have consolidated and supervisory authority over so-called Tier 1 financial holding companies, or FHCs. Tier 1 FHCs are defined in the administration’s proposal as those firms whose failure could pose a threat to financial stability because of their combination of size, leverage and interconnectedness.

The proposal recommends that Tier 1 FHCs face stricter capital, liquidity and leverage requirements and more robust risk management standards. Legislation would establish the criteria for what firms would be designated as Tier 1 FHCs. The Fed’s consolidated supervision over Tier 1 FHCs should extend to the parent company and any regulated and nonregulated subsidiaries in the United States or elsewhere, the proposal says.

To advise the Fed on identifying firms that pose potential systemic risks, the administration’s proposal calls for creating the Financial Services Oversight Council. The council would comprise the treasury secretary, the Federal Reserve chairman and the heads of various regulatory agencies, including the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), the FDIC and the Federal Housing Finance Agency (FHFA).

The council also would include the directors of the National Bank Supervisor and the Consumer Financial Protection Agency (CFPA) – two new entities proposed by the administration.

The expanded Fed powers are controversial. Arguments against providing the central bank with broad powers to oversee large financial groups center on the Fed’s track record in past crises, as well as its ability to balance its new regulatory authority with its responsibility for monetary policy.

In a July 2009 report on financial regulatory reform, the Investors' Working Group (IWG) argued that the appropriate way to monitor and respond to systemic risks is through a Systemic Risk Oversight Board. The IWG noted the Fed's competing responsibilities, such as guiding monetary policy while managing the U.S. payments system. (The IWG is an independent panel of investment and regulatory experts co-sponsored by the Council of Institutional Investors and the CFA Institute Centre for Financial Market Integrity.)

The IWG's report said the Fed's credibility has been "tarnished" by its pursuit of easy credit policies and "lax regulatory oversight that let institutions ratchet higher their balance sheet leverage and amass huge concentrations of risky, complex securitized products." The report also cited serious concerns with the Fed's regulatory failures, such as its refusal to police mortgage underwriting or impose suitability standards on mortgage lenders, and the heavy influence banks have on the central bank's governance.

The Obama administration's reform proposal acknowledges that federal banking regulators weren't swift enough in developing rules for subprime and other nontraditional mortgages. The proposal notes that recent Federal Reserve regulations have been strong but "quite late" in coming. The administration's response would be to give the new CFPB the regulatory rulemaking powers to act comprehensively to address emerging consumer protection concerns (the CFPB is discussed further under **New Consumer Agency**).

The administration's proposal notes that federal banking agencies took until December 2005 to propose – and then until June 2007 to finalize – supervisory guidance on consumer-protection concerns over subprime and nontraditional mortgages. The proposal says the worst of these mortgages were originated in 2005 and 2006. The administration argues that an agency such as the CFPB "could have acted much more quickly" and potentially saved more consumers, communities and institutions from significant hardship.

The administration's plan to oversee systemically important, or "too big to fail,"

institutions calls for a "resolution regime" to avoid any disorderly resolutions of failed bank holding companies or Tier 1 FHCs. The proposal envisions using the existing resolution process the FDIC follows in taking over failed banks.

The ABA has said the administration's plan for resolving the failures of large, systemically important firms would have to be more concrete – for example, setting clear rules on the accountability and financial loss of the failed institution's management, board and top shareholders.

The administration wants a more orderly process to wind down systemically interconnected firms during a financial crisis. Amid stressed economic conditions, when troubled firms file for bankruptcy (as in the example of Lehman Brothers Holdings Inc.), regulators may find it difficult to manage the firm's resolution in a way that limits systemic risk.

The ABA is against the notion of potentially turning over the resolution process to the FDIC. (The administration didn't propose specifically that the FDIC have this authority, though the idea has circulated among regulators.) Doing so potentially could undermine trust in the deposit insurance system and put the deposit insurance fund at risk of being used to pay for resolutions outside of those the FDIC normally conducts, the ABA says.

Whether or not the Fed gains exclusive powers as the nation's systemic risk regulator will depend on legislation. Rep. Barney Frank (D-Mass.), chairman of the House Financial Services Committee, doesn't support giving the Fed that exclusive power.

On another note, the Obama administration also has proposed that the Federal Reserve Board receive prior written approval from the treasury secretary for emergency lending under its "unusual and exigent circumstances" authority, the aim of which would be to improve accountability.

### **New Consumer Agency**

The administration's plan calls for creating a new Consumer Financial Protection Agency (CFPA) – a federal agency with supervisory, examination and enforcement

authority. The CFPB would have jurisdiction over credit products, such as credit cards and mortgages, in addition to savings and payment products.

Banking trade groups oppose creating an entity to oversee consumer policy and enforcement that is separate from the supervision of financial institutions for safety and soundness. These groups also want any new consumer protections to focus particularly on nonbanks, such as specialty mortgage finance companies that originated a significant majority of the subprime and exotic mortgages that have contributed to the downturn in the housing market. Those who favor the CFPB argue that federal regulators tend to put banks' supervision and oversight ahead of consumer protection.

As proposed by the administration, the CFPB would have sole authority to promulgate and interpret existing consumer financial services and fair-lending laws, including the Truth in Lending Act and the Community Reinvestment Act (CRA). The CFPB's board would have the power to apply "tailored protections" to existing consumer-protection and fair-lending statutes to address, say, disclosures or restrictions on contract terms or sales practices. The CFPB should have the same rulemaking authority under future consumer-protection laws concerning credit, savings or collection markets, among others, the administration's proposal says.

In early July, Frank introduced the Consumer Financial Protection Agency Act of 2009. H.R. 3126, as it is known, differs in part from the administration's proposed CFPB. For example, oversight of the CRA would remain with federal banking regulators. In addition, the legislation still makes reference to the OCC and the OTS, agencies that would be merged into a new National Bank Supervisor under the administration's proposal. Congress plans to address a more unified approach to banking supervision through separate legislation.

Frank originally had planned to mark up the legislation before the congressional recess in August. But he said in late July that he would delay a vote on the bill until September.

The bill's language defines financial activities such as credit, mortgage and title

insurance as coming under the CFPB's jurisdiction. Banking trade groups, such as the National Association of Federal Credit Unions (NAFCU), have argued that the CFPB should be "narrowly focused" on traditional products and shouldn't have any regulatory powers over credit, mortgage and title insurance.

For their part, trade groups that represent insurers, agents and brokers, financial planners and insurance agencies have called for the legislation's language to be tightened and for all insurance products and practices to be excluded from the CFPB's oversight. These groups, which include the American Council of Life Insurers (ACLI), the National Association of Mutual Insurance Companies (NAMIC) and the Property Casualty Insurers Association of America (PCI), have raised concerns that the bill's language potentially could include other forms of insurance under the CFPB's jurisdiction.

The legislation, for example, defines financial activities that come under the CFPB's authority to include financial and other related advisory services. That extends to, for example, tax-planning or tax-preparation services.

Banking trade groups have other concerns with the proposed CFPB. These include the potential for added compliance costs, as well as the funding mechanism for the agency's budget. The legislation envisions fees and assessments on institutions that the CFPB supervises.

Another industry concern is the CFPB's ability to develop guidelines and regulations for standard consumer financial products and services. Banks would have to offer these products or services at, or before, the time an alternative product or service is offered.

The ABA contends that these government-designed products would have a "preferred position" over financial products designed by banks and financial institutions. ICBA points out that the new agency wouldn't have a definitive mandate to distinguish between products offered by national banks and those offered by community banks that operate exclusively in small geographic regions.

An additional concern some trade groups have with the legislation is that it could alter the dual banking system in which national banks and federal thrifts are regulated at the federal level, while state banking regulators oversee state banks. Among other things, the legislation would apply state consumer laws – such as those relating to unfair and deceptive practices; consumer fraud; and repossession, foreclosure and collection – to national banks and federal savings associations.

**FTC’s Role in Consumer Protection**

A key issue in any legislation creating the CFPA or bolstering consumer protection in financial products and services is what role the Federal Trade Commission (FTC) would play. The FTC, founded in 1914, has limited jurisdiction to protect consumers in the financial products arena, where it operates under a restrictive rulemaking statute. The FTC’s enforcement authority, for example, doesn’t extend to banks, savings and loans and certain types of credit unions. The administration’s reform proposal acknowledges that the FTC has limited tools and resources to promote “robust compliance” of nonbank institutions.

The administration’s proposal would transfer the FTC’s primary protective authority over financial products and services to a new consumer agency. But it does call for the FTC to have standard rulemaking authority with regard to unfair and deceptive practices for the areas of commerce that would remain under its authority. Some lawmakers oppose transferring FTC authority to a new consumer protection agency.

The FTC would retain shared authority with the CFPA to respond to fraud in services such as advance fee loans, credit repair and debt negotiation, as well as fraud in foreclosure rescue or mortgage-loan modification programs. The administration’s proposal also would give the FTC enhanced law-enforcement powers such as the ability to levy civil penalties for violations of Section 5 of the FTC Act, which prohibits unfair or deceptive practices.

Congress already is moving toward broadening the FTC’s authority over certain financial services and programs. The Consumer Credit and Debt Protection Act (H.R. 2309), for example, would give the FTC broader rulemaking powers under the Administrative Procedure Act, the federal law that guides how federal agencies propose and make regulations.

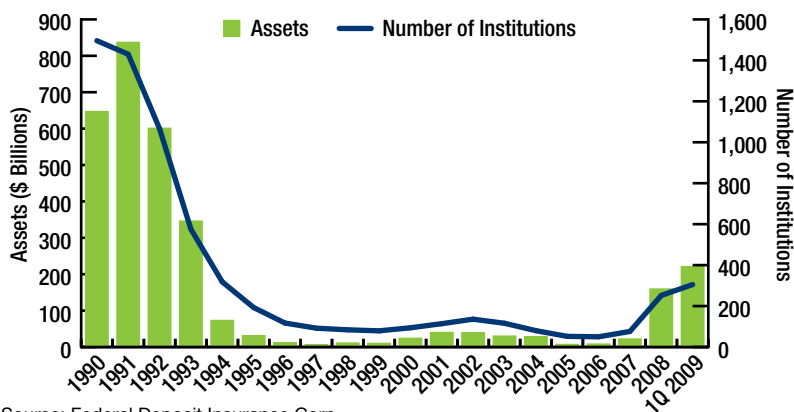
H.R. 2309 would give the FTC those broader powers to address unfair and deceptive practices for products such as payday lending, automobile financing, mortgage and foreclosure rescue programs and debt settlement, according to Rep. Bobby L. Rush (D-Ill.), a cosponsor of the legislation. More broadly, the FTC’s chairman testified in July at a hearing of the House Commerce, Trade and Consumer Protection Subcommittee that APA rulemaking authority would strengthen the FTC’s ability to respond quickly to widespread problems.

**More Deposit Fund Changes Proposed**

The notions of “too big to fail” and systemic risk also have been addressed in legislation that would change key aspects of how the FDIC calculates and charges premiums for its deposit insurance fund, or DIF.

Similar to the method the FDIC used for a special assessment in May, the Bank Accountability and Risk Assessment Act of 2009 (H.R. 2897) would base assessments on assets rather than domestic deposits. The legislation, introduced by Rep. Luis Gutierrez (D-Ill.), would take a broader view of an institution’s assessment base, considering risks throughout the holding company and other affiliates of the depository institution. It would require the FDIC, then, to calculate assessments based on total assets minus tangible equity.

Exhibit 2  
**U.S. Banking – Problem Institutions (1990-1Q 2009)**



Source: Federal Deposit Insurance Corp.

H.R. 2897 also would establish an annual systemic-risk premium on systemically important financial institutions. Gutierrez and groups such as IBCA, which supports the bill, argue that depositors and other creditors of too-big-to-fail institutions enjoy superior protection to those of smaller banks.

By establishing a risk-based method for calculating assessments, Gutierrez's bill seeks to address perceptions of unfairness in how deposit insurance premiums are calculated across the banking sector. Banks with less than \$10 billion in assets pay about 30% of the total assessment base, though they hold only about 20% of total bank assets, according to a statement by Gutierrez.

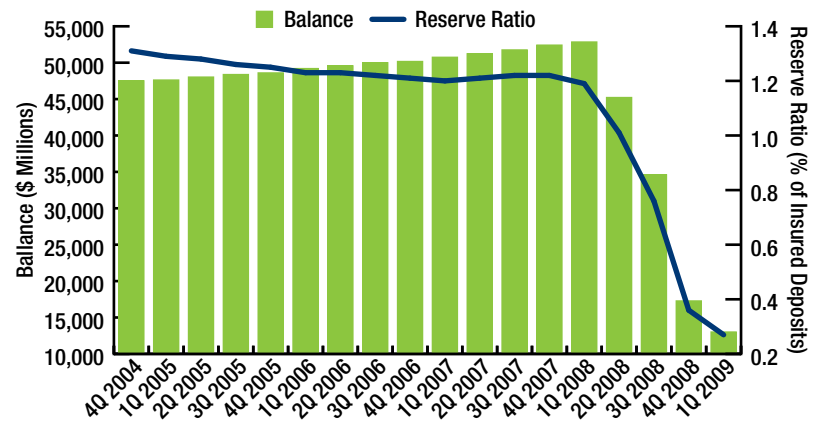
The DIF has faced added stress recently, with 25 bank failures in 2008 and another 57 through July 17, 2009. Through the first quarter of 2009, 305 institutions with total assets of \$220.0 billion were on the FDIC's "problem list" of banks under heightened regulatory scrutiny. That was up from 252 banks with total assets of \$159.4 billion in the fourth quarter (see **Exhibit 2**).

Through the first quarter of 2009, the DIF's reserve ratio stood at 0.27%, down from 1.19% as of March 31, 2008 (see **Exhibit 3**). The first-quarter 2009 ratio was the lowest for a combined bank and thrift insurance fund since March 31, 1993, when the ratio stood at 0.06%, according to the FDIC. What's more, the potential for further dilution to the DIF has increased since the guarantee on deposit insurance limits was increased in October 2008 to \$250,000 from \$100,000.

Legislation signed in May by President Obama extended the temporary increase in coverage to \$250,000 through 2013. It also increased the FDIC's borrowing authority with the Treasury Department from \$30 billion to \$100 billion. That potentially helped to take some of the strain off the DIF, though the legislation does allow the FDIC to take into account the temporary coverage increase when it sets future assessments.

The legislation, part of the Helping Families Save Their Homes Act of 2009, followed a somewhat controversial interim rule proposed by the FDIC in February 2009. The FDIC wanted to charge the industry a special, emergency assessment of 20 basis

### Exhibit 3 U.S. Banking – FDIC Deposit Insurance Fund Balance & Reserve Ratio (4Q 2004-1Q 2009)



Source: Federal Deposit Insurance Corp.

points to help replenish the DIF. A basis point represents one cent for every \$100 of domestic deposits.

But the FDIC received thousands of comments noting the adverse impact the assessment would have on banks' earnings and lending capacity, particularly at a time of stress in the economy. Seeking to strike a balance between preserving lending capacity and meeting its intent to cover projected costs to the DIF through assessments, the FDIC board voted in May to levy a special assessment of only five basis points.

In addition, rather than assessing an institution based on deposits, the rule based the assessment on an institution's assets minus its Tier 1 capital. To ensure that institutions wouldn't pay more than 20 basis points proposed under the interim rule, the special assessment was capped at 10 basis points of an institution's domestic deposits. The FDIC did say at the time that an additional special assessment probably would be needed in the fourth quarter, though the amount was uncertain.

### Proposed Private-Equity Rules For Failed Bank Takeovers

Regulators have been hoping that more private equity would flow into the banking sector. In September, the Federal Reserve changed its rules for bank holding companies, allowing investors to acquire larger stakes in banks without having to register as BHCs.

In recent months, the FDIC has been turning more to loss-sharing and participation

agreements with private buyers as it seeks to conserve funds available for resolutions of failed banks.

In July, the FDIC unveiled a controversial proposal for investors acquiring failed banks that would require private equity investors to maintain a Tier 1 leverage ratio of 15% for at least three years. Potential investors in failed banks have viewed the capitalization provision as particularly onerous, considering that regulators require a 5% Tier 1 capital ratio for established banks to be considered well capitalized and a ratio of 8% for new banks.

The Private Equity Council, a Washington, D.C.-based trade group, said after

the proposal had been released that it would deter future private investments into banks that need the funds. The group called for changes during the proposal's comment period that would help private capital to flow into the banking system.

The FDIC's inclusion of provisions for cross guarantees also dismayed potential private equity investors. Such investors with a majority investment in more than one insured depository institution would be required to pledge their proportionate interests in those institutions to the FDIC. The thinking behind this provision is that those interests would be used to pay for any losses to the deposit insurance fund should another bank controlled by the private investor fail.

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August 3, 2009

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