A.M. BEST

METHODOLOGY OCTOBER 4, 2004

Rating Funding Agreement-Backed Securities

This document describes A.M. Best Co.'s approach to rating the securities and related programs where the notes to be rated are secured by funding agreement contracts issued by U.S. life insurers. It should be read in conjunction with A.M. Best's Ratings & the Treatment of Debt, at *http://www.ambest.com/debt/debtmethod.pdf,* which summarizes the relationship between Best's Financial Strength Ratings (FSRs), Issuer Credit Ratings (ICRs) and debt ratings.

Summary

A number of the large U.S. life insurance companies have increased the volume of their institutional spread business by issuing funding agreement-backed securities (FABS) through private placement securitization vehicles such as European Medium Term-Note (EMTN) and Global Medium Term-Note (GMTN) programs, as well as the new Securities and Exchange Commission (SEC)-registered programs. As such, A.M. Best will assign ratings to each FABS issuance under these programs.

A.M. Best views this business as an alternative form of long-term financing for highly rated companies with considerable expertise in asset/liability and investment management.

Through the typical FABS program structure, investors are exposed to the inherent credit, liquidity and business risks of the sponsoring insurance company. Therefore, A.M. Best will utilize the credit market scale for FABS ratings, assigning an ICR to the program and the various tranches. The ICR, which is translated from Best's FSR scale, is A.M. Best's opinion as to the ability of the issuing insurance company to meet its senior obligations. Notes issued under a standard FABS program will receive the same ICR as the sponsoring insurance company, reflecting that: (1) the underlying funding agreements (FAs) are obligations of the insurer's general account, and (2) the FAs are *pari passu* with other insurance contracts issued by the company based on the regulations of the insurer's state of domicile.

A.M. Best's analysis will entail reviewing the insurance laws of the state of domicile for each issuer, as well as soliciting independent legal opinions in states where the regulations are unclear. The FABS programs' legal and economic structures also must be analyzed, including how well the payment requirements of the FAs and notes are coordinated.

In addition, U.S.-issued FAs and FABS, like traditional guaranteed investment contracts (GICs), impact liquidity, as they are—for the most part—privately placed, unregistered instruments, although a few programs have been SEC registered, and more registrations are expected. A.M. Best will review the insurers' asset/liability management processes to ensure that a close match is maintained between the funding agreements' assets and liabilities.

The rating analysis will be similar to considering the risks inherent in other spread-based products, such as GICs, which generally are issued to pension plans and municipalities. Since the net proceeds from FABS issuances are used in matched funding operations, A.M. Best views GICs and FAs as operating leverage, not as financial leverage. A.M. Best's analysis will incorporate the organization's overall ability to support the institutional spread-lending business in establishing limits for these products on a company-by-company basis. Companies that issue substantial volumes of "stable value" products, or that have the majority of their liabilities in institutional investment products, are likely to experience downward pressure on their ratings.

Overview

For the increasing number of insurers interested in participating in institutional investment markets, FABS programs have been an attractive alternative to GICs and short-term FAs with embedded put options. FAs are more appropriate than GICs for use in securing note issuance programs, due to the lack of life, health or employment contingencies in the FA contracts.

Over the past several years, A.M. Best has observed considerable activity in the FABS arena as companies look to diversify funding sources, lengthen liability durations and reduce their overall cost of funds.

In broad terms, FAs are nonqualified annuities or annuity-like instruments that are designed specifically to generate regular cash flows to service the debt on short-term or medium-term notes issued through a securitization vehicle—a trust and/or special purpose vehicle (SPV). The structure transfers the credit quality of a policyholder claim at the insurance company to the notes of the SPV. FAs are governed by laws of the home state of the underwriting insurer, whereas the notes, like most U.S. corporate securities, ordinarily are governed by New York law.

FABS are targeted to the institutional market —banks, pension funds and other insurers. The notes offer investors access to high quality issuers at a level higher than senior bondholders, with attractive relative spreads. Although the core group of FA providers has been stable, new issuers have entered the market through both the institutional and retail avenues. The FABS market has grown to more than $150 billion issued, providing a complement to a life insurer's existing business lines.

Funding Agreement-Backed Securities Programs

In the late 1990s, substantially all FABS were issued under EMTN programs and sold to investors in Europe, Asia and Australia. The owner and holder of the FA is an SPV located outside of the United States—typically in the Cayman or Channel islands. Since the offshore SPV is not an insurance company, the regulatory process is streamlined. Insurers that issue the notes through these structures are not subject to European regulatory oversight, as they are not directly selling insurance policies. In addition, the notes are not subject to U.S. tax laws.

The programs were set up to issue amounts in various European currencies. To effectively eliminate mismatch, the terms of the FAs match the terms of notes to be issued by the SPV. Additionally, the insurers and SPVs might enter into cross-currency and interest-rate swaps with swap counterparties to reduce the risk of currency and payment mismatches.

Direct purchase of the notes is restricted to non-U.S. investors; the notes are listed in the bond section of the Luxembourg Stock Exchange. Maturities generally range from three to 30 years, although five to seven years is more common. Once the notes are "seasoned" (i.e., out of the restricted period, approximately 40 days), they can be traded actively without limitations.

Distributors eschewed selling FABS in the United States until the insurance regulators could be satisfied that the notes were investment products rather than insurance contracts. In 2000, the volume of issuances expanded with the introduction of GMTN programs. These programs essentially are the same as EMTN programs, except that issues are available both to general investors outside the United States and to qualified institutional buyers within the United States under Rule 144A.

In the GMTN program structure, the securitization vehicle is a domestic entity—usually a Delaware business trust or limited liability company. A.M. Best data on the FABS market indicate that GMTN programs primarily are being utilized, although the EMTN programs remain active. Additionally, before actively issuing FABS under their own name, insurers utilized conduit programs such as the Premium Asset Trust Series and Structured Asset Repackaged Trust Series, which are managed by broker-dealers.

The insurer establishes the maximum aggregate principal amount for its FABS program, but the notes can be issued in unlimited series or tranches. The notes, which are nonstandard and

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Methodology

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designed to meet the diversification needs of investors, can be a fixed or floating rate or zero-coupon. A.M. Best will rate both the program and the particular series within each program.

Recently, some FABS issuers have established SEC-registered medium-term note programs. These enable an insurer to sell notes to U.S. retail buyers and to a broader range of U.S. institutional buyers than the predecessor programs, thus diversifying the investor base. Additionally, registered programs are priced more attractively compared with the private placement market, and retail funding helps to smooth out the uneven inflows and outflows of institutional note transactions. Although SEC-registered programs currently have onerous reporting requirements and a lengthy approval process, A.M. Best expects the process to gain efficiency in the future.

Program Structure

Within FABS program structures, the SPV or trust is a bankruptcy remote entity. The SPV generally has no prior business history, and its sole purpose is to issue notes secured by FAs of the underlying insurer. The FA is a direct senior obligation of the insurance company. The FA, which is held by a trustee, is the primary asset of the SPV and the source of funds to pay the noteholders in the program. The terms of the FAs (rate, maturity and principal) generally match the terms of bonds. If the issuer fails to satisfy the stated contract terms, the noteholders have recourse to the FA issued to the trust or SPV, but the notes are nonrecourse to the insurer.

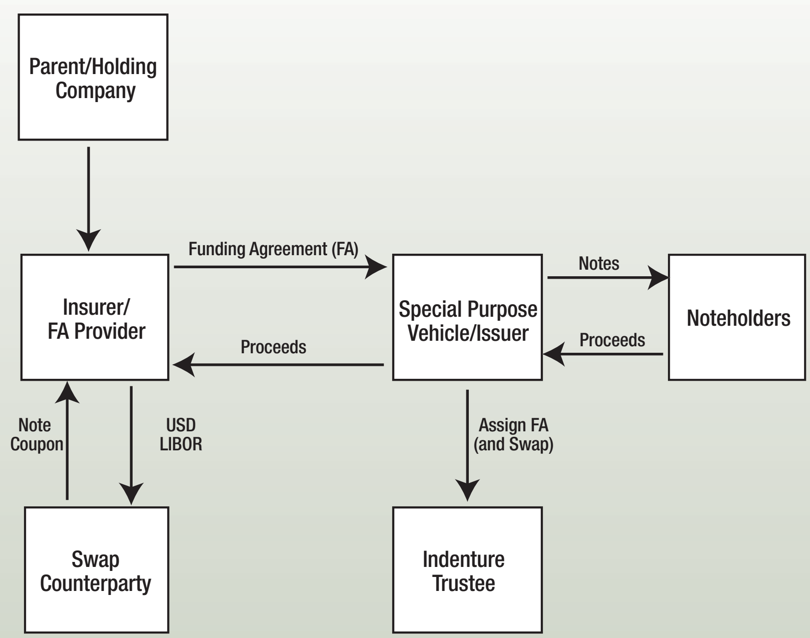
The insurer and/or the SPV also might engage in swap agreements in order to match the cash flows from the FA with the obligations of the SPV to make payments on the notes. Typically, swaps are used when the notes are denominated in a different currency than the FA. Where swaps or other derivatives are used, this creates an additional source of assets, as well as liabilities, for the SPV.

One approach that companies have utilized in FABS structures is where the FA is written in the foreign currency and the insurer makes the foreign currency payments by means of a swap contract. An alternative method has the FA written in U.S. dollars, and the SPV would swap the FA payments into the necessary foreign currency before passing them on to the noteholders.

The SPV is needed to convert a nontradable insurance product (the FA) into liquid investment products (the notes). The notes are a form of securitized instrument in that they pass along the proceeds of the FA in a structured manner, and derivative, as they track the behavior of another instrument, the bond or note. Hence, the FAs and the notes have analogous payment structures.

In offshore programs, any funds remaining at the SPV level after all notes mature are funneled to a charitable organization. In certain domestic programs, leftover funds would be returned to a beneficial owner other than the insurer. In general, when the notes mature the SPV terminates and returns any excess funds to the insurer.

Typical FABS Structure



The FA is assigned to the trustee for the benefit of the notes' investors. Security interest perfection is achieved by the trustee who takes possession of the funding agreements. Additionally, the trustee might file financing statements in the state where the trust was incorporated and/or the insurer's state of domicile, naming the SPV as the debtor and the trustee as the secured party for the benefit of the note investors.

Key Rating Factors

1. Issuer Credit Rating

The ICR of the issuing insurance company is A.M. Best's opinion of the ability of the insurer to meet its senior obligations. Notes issued under a standard FABS program will receive the same ICR as the sponsoring insurance company, reflecting that: (1) the underlying FAs are obligations of the insurer's general account and (2) the FAs are *pari passu* with other insurance contracts issued by the company based on the regulations of the insurer's state of domicile.

The rating assigned to the program generally is assigned to each tranche. An exception would be if credit risk is embedded in any of the tranches in addition to the insurer's credit risk in these tranches (e.g. credit-linked or index features), which might cause the rating of the notes to be notched lower. A.M. Best believes these exceptions are uncommon. Programs/notes that are credit enhanced might be assigned a higher rating than the insurer's ICR. These cases also are atypical.

2. State Regulatory Opinions on Priority of FAs

A crucial issue is whether the FAs are *pari passu* with policyholder claims; that is, whether the insurer's state of domicile treats the FA as an insurance liability of the general account. Many states have specific language in their regulations, some of which recently were amended, stating that FAs are considered policyholder liabilities and therefore receive the highest priority of claims. In states where FAs are junior to general account policyholder obligations, the rating of the program/notes, all other factors being equal, would rank below that of the insurance operating company.

A.M. Best will review the insurance laws of the state of domicile for each FA issuer, as well as solicit independent legal opinions, especially for states where the regulations are unclear. Investors might take comfort in the outcome of litigation from the Executive Life, Mutual Benefit Life and Confederation Life insolvencies, which concluded that GICs were policyholder obligations, although other courts might render different opinions.

3. FABS Structure

An important aspect of relating the insurer's ICR to the rating of the program/notes is to understand the relationship between the FA and the note program. The legal and economic structures must be analyzed, including how well the payment requirements of the FA and notes are coordinated. Some note programs tie the note payments to risks other than the insurer's credit, and these risks must be evaluated to determine whether they create downward pressure on the rating. Furthermore, since the net proceeds from funding agreements are used in matched funding operations, A.M. Best views this as operating leverage, not as financial leverage.

The analysis of the FABS program structure is similar to that of a leveraged lease or other structured-financing arrangement. A major consideration in the analysis is the extent to which state insurance laws govern. The inquiry also has legal components relating to the enforceability of the notes' security interest provisions under the commercial laws of the insurer's and the SPV's domicile. Finally, the analysis should consider (1) how direct the investors' recourse is to the FA; (2) whether the flow of FA payments to investors is impeded; and (3) how strictly the noteholders can enforce their security interest in the FA.

4. ALM and Liquidity Factors

FA providers must employ sophisticated asset/liability management (ALM) techniques and possess expertise in fixed-income and portfolio management, as well as proficiency in the structuring and management of the FABS program—similar to the skill set necessary for managing a profitable GIC issue.

Although the FA's assets generally are segregated only notionally in the insurer's general account, a close match between the funding agreement's assets and liabilities should be maintained. However, this match could be disrupted, for example, when interest rates decline and the duration of certain long-term obligations shortens, which often occurs with collateralized mortgage obligations (CMOs).

To compensate, an insurer might fund a floating-rate FA with fixed-rate assets and then "swap" the resulting fixed payments for floating-rate payments. Although this mitigates interest risk, the insurer still is exposed to credit risk.

In general, accepting more asset risk can enhance spreads for the insurer, though this might be at the expense of increased asset/liability mismatches. The risks are similar to those of other spread-based products, such as pension GICs. A.M. Best views GICs and FAs as commodity products with relatively low margins, as the products have few differentiating features. Also, companies might try to augment spreads by using less-liquid, more exotic asset classes, which present additional investment risks.

The greater an insurer's exposure to these institutional liabilities, the greater the stress on an insurer's liquidity profile, especially in certain situations such as a rating downgrade or a contract containing negative covenants. Further, if an insurer has a large portion of its total liabilities due in a year or less, it is substantially exposed to a material change in investor sentiment. If investor sentiment turns negative, it might cause a "run-on-the-bank" scenario that can damage franchise value and deter investors.

Put options embedded within FAs give rise to liquidity concerns and event risk. FA providers must employ effective asset/liability management techniques, model the quick roll-off of putable FAs and maintain adequate sources of liquidity. The longer the duration of an insurer's asset portfolio, and the lower the quality, the less likely the company will be able to handle a "run-on-the-bank" scenario where a significant portion of assets potentially would need to be divested at a loss. Even so, A.M. Best has observed that few putable products are being issued by life insurers, and even rarer are issuances of seven-day put options of the kind that created the liquidity crisis at General American in 1999.

For FAs that do not have puts, rollover risk is an issue. Similar to debt obligations, as FAs mature, principal payments must be made. If cash flows are not realized through a new note issue or GIC sale, assets might need to be disposed of (at a less-than-opportune time) to satisfy the maturing obligation. To be clear, insurers issuing FAs within FABS programs do not necessarily also offer putable FAs. While there is rollover risk at maturity, a block of FAs securing a note issuance program is generally more stable and predictable than a block of short-term putable FAs.

The FABS market is not "self-policing" like the commercial paper market, where outstanding paper might be left to mature on schedule. An orderly roll-off of an insurer's FA liabilities might not be possible, since the exercise of outstanding put options is unpredictable, as evidenced by what occurred at General American. The liquidity issues at General American were exacerbated due to the use of reinsurance with recapture provisions. Although the use of reinsurance is atypical in the FA marketplace, A.M. Best must monitor its usage and incorporate it into its overall analysis.

5. Risk-Reduction Techniques

A.M. Best analysts will look for certain risk-reduction techniques, including the following:

- Cash-flow matching;
- Diversification of assets;
- Laddered liability maturities;
- Surplus and capital backed with liquid assets;
- Durable line of credit;
- Commercial paper facilities;
- Repurchase agreements; and
- Liquidity options from an investment dealer.

Rating Process

In addition to holding discussions with the insurer to assess the transaction's structure, economics and modeling of the FA's future performance, A.M. Best will obtain and review documentation for each program, including:

- Presentations to potential investors;
- Offering memorandum, term sheets and indenture;
- Operative documentation of the funding agreement;
- Documentation of third-party credit support (if applicable);
- Legal opinions of the FA and SPV; and
- Regulatory actions and communications on any significant aspect of the FA or SPV.

When A.M. Best analysts have received all the necessary information and documentation, conferred with all relevant parties and completed their assessments, they will recommend a rating to the appropriate committee at A.M. Best.

The rating committee reviews the recommended rating and makes the final decision. Upon approval of a rating assignment, A.M. Best will provide the insurer with a rating letter that conveys the rating and the requirements for maintaining it.

Maintaining the rating requires the insurer to provide A.M. Best with periodic updates on its FABS programs, timely notice of material changes in the performance of the assets backing the FA, and notice of any regulatory actions that have the potential to materially affect the transactions. Meetings with the principal parties to the transactions also are expected.

A.M. Best's Ratings

A.M. Best's proprietary financial strength rating scale, with the two broad groupings of Secure and Vulnerable, is the standard for insurance market participants. A.M. Best's issuer credit and debt ratings use a credit scale more familiar to capital market participants, which is divided into the two categories of Investment Grade and Non-Investment Grade.

The starting point for all rating-related activities is Best's interactive financial strength analysis. Only where there is an existing Best's Financial Strength Rating (FSR) on the primary insurance company(ies) within an organization will A.M. Best assign issuer credit and debt ratings. Using the FSR as the analytical genesis for all subsequent rating activity recognizes that the fiscal resources of most insurance organizations stem from the financial strength of the operating insurer(s).

The financial strength assessment involves ongoing, in-depth reviews and incorporates a host of public and proprietary financial data and information grouped into three evaluative categories:

• **Balance Sheet Strength** — This is a major determinant in a company's ability to meet its current and ongoing obligations to policyholders. For an insurer to remain viable in the marketplace, it must perpetuate a financially strong balance sheet for its policyholders.

• **Operating Performance** — When evaluating operating performance, A.M. Best's analysis centers on the stability and sustainability of the company's sources of earnings in relation to the liabilities that are retained by the company.

• **Business Profile** — The factors that comprise an insurer's business profile drive current and future operating performance and, in turn, can affect long-term financial strength and the company's ability to meet its obligations to policyholders.

Full details on each aspect of A.M. Best's financial strength rating process are available at *www.ambest.com/ratings/index.html.*

GUIDE TO BEST'S RATINGS

A Best's Rating reflects an independent opinion, based on a comprehensive quantitative and qualitative evaluation, of a company's balance sheet strength, operating performance and business profile. Best's Ratings are not a warranty of a company's financial strength and ability to meets its financial obligations.

Financial Strength Ratings

A **Best's Financial Strength Rating** is an opinion as to an insurer's ability to meet its obligations to policyholders.

	Rating	Descriptor
Secure	A++, A+	Superior
	A, A-	Excellent
	B++, B+	Very Good
Vulnerable	B, B-	Fair
	C++, C+	Marginal
	C, C-	Weak
	D	Poor
	E	Under Regulatory Supervision
	F	In Liquidation
	S	Suspended

Rating Modifiers

"u"	Under Review
"pd"	Public Data
"s"	Syndicate

Affiliation Codes

"g"	Group
"p"	Pooled
"r"	Reinsured

Not Rated Categories (NR)

NR-1	Insufficient Data
NR-2	Insufficient Size and/or Operating Experience
NR-3	Rating Procedure Inapplicable
NR-4	Company Request
NR-5	Not Formally Followed

Long-Term Credit Ratings

A.M. Best uses its long-term credit rating scale when assigning:
- **Debt Ratings** (an opinion as to the issuer's ability to meet its financial obligations to security holders when due) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior-most obligations).

	Rating	Descriptor
Investment Grade	aaa	Exceptional
	aa	Very Strong
	a	Strong
	bbb	Adequate
Non-Investment Grade	bb	Speculative
	b	Very Speculative
	ccc, cc, c	Extremely Speculative
	d	In Default

Ratings from "aa" to "ccc" may be enhanced with a "+" (plus) or "-" (minus) to indicate whether credit quality is near the top or bottom of a category, and a "u" modifier for Under Review. Ratings shown as (*italicized*) denote indicative shelf ratings. Issuer Credit Ratings may also be assigned a "pd" modifier, which indicates that a company does not subscribe to A. M. Best's interactive rating process.

Short-Term Credit Ratings

A **Best's Short-Term Credit Rating** is an opinion as to the ability of an issuer to honor obligations having maturities generally less than one year, such as commercial paper.

	Rating	Descriptor
Investment Grade	AMB-1+	Strongest
	AMB-1	Outstanding
	AMB-2	Satisfactory
	AMB-3	Adequate
Non-Investment Grade	AMB-4	Speculative
	d	In Default

Rating Outlook

Best's Ratings (A++ to D, aaa to c and AMB-1+ to AMB-4) are assigned a Rating Outlook that indicates the potential direction of a company's rating for an intermediate period, generally defined as the next 12 to 36 months. Rating Outlooks are as follows:

Positive	Indicates a company's financial/market trends are favorable, relative to its current rating level, and if continued, the company has a good possibility of having its rating upgraded.
Negative	Indicates a company is experiencing unfavorable financial/market trends, relative to its current rating level, and if continued, the company has a good possibility of having its rating downgraded.
Stable	Indicates a company is experiencing stable financial/market trends and that there is a low likelihood that its rating will change in the near term.

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