

September 29, 2011

Additional Information

Criteria:

Life Settlement Securitization

Securitization of Annuities

Best's Impairment Rate and
Rating Transition Study

Best's Idealized Default Matrix

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www.ambest.com/ratings/methodology

Securitization of Period-Certain and Life-Contingent Structured Settlements

A structured settlement is an agreement between a claimant and a defendant, whereby the claimant agrees to settle a lawsuit in exchange for periodic payments to be made by the defendant to the claimant over time. Structured settlements are a popular method for settling personal injury, product liability, medical malpractice and wrongful death cases. The defendant discharges its obligation by purchasing an annuity from a highly rated life insurance company.

In general, there are two varieties of annuities utilized in structured settlements: a) period-certain annuities that generate guaranteed, periodic payments for a defined term to the annuitants and can be fixed or can escalate based on a specified compounding rate and/or inflation rate; and b) life-contingent annuities in which specified payments are made to annuitants until they die. There also are annuities that combine period-certain and life-contingent features.

Structured settlements have been securitized in asset-backed securities transactions for at least 11 years. Since 2001, such transactions have been greatly facilitated by the enactment of transfer laws that require court orders before structured settlement cash flows can be purchased. Court-ordered transfers have virtually eliminated diversion risk – the risk that claimants in structured settlements who have sold their annuity cash flows to purchasers would divert such cash flows back to their own accounts in violation of their sales agreements. This methodology summarizes how A.M. Best will assess structured settlement securitizations involving period-certain and/or life-contingent annuities.

Historical Tax Issues Associated With Structured Settlements

Structured settlements – which often involve periodic payments over a long term – evolved as a way to foreclose claimants from improvidently exhausting their awards.

The federal tax characterization of an award matters both to the claimant and to the defendant. Although lump-sum case-settlement payments always have been excluded from the claimant's income – as specified in Section 104 of the Internal Revenue Code (IRC) – the tax treatment of a structured settlement award once was uncertain. A claimant's annuity payments received from a structured settlement, for example, might formerly have been included in the claimant's income, even though clearly part of a tort settlement. In the late 1970s, the Internal Revenue Service (IRS) issued several rulings suggesting that tort-settlement periodic payments would be excluded from the claimant's income as long as the claimant could not control or accelerate the payments. In 1982, an amendment to Section 104 of the IRC and enactment of Section 130 of the IRC clarified the tax treatment of



structured settlements and revealed their potential advantages.

Section 130 allows defendants to fund their obligations via annuities and claimants to exclude such payments from their income, as long as (among other things) the payments are “fixed and determinable as to amount and time of payment” and “cannot be accelerated, deferred, increased, or decreased by the recipient.” In response to claimants’ desire to monetize such periodic payment rights, a market developed in which companies purchase a claimant’s rights to future payments in exchange for a lump sum. This business of monetizing anticipated payments is known as “factoring,” and the firms engaged in it as “factoring companies.” But the industry faced a problem in the possibility of factored structured settlements payments being deemed “accelerated,” no longer being deemed “fixed and determinable,” and accordingly, being denied the favorable tax treatment otherwise accorded tort settlement proceeds. Factoring, it was feared, might disqualify payments from being excluded either from the payee’s taxable income under Section 130 of the IRC or from the factoring company’s income. But new legislation, prescribing a method to accomplish a factoring transaction while retaining favorable tax treatment, essentially eliminated this possibility.

The Victims of Terrorism Tax Relief Act of 2001 added Section 5891 to the IRC to govern the tax treatment of structured settlement factoring transactions. It imposes a stiff excise tax on anyone acquiring structured settlement payment rights in a factoring transaction, but makes exceptions for any factoring transaction “approved in advance in a qualified order.” Approval essentially depends on a finding that the transaction is in the best interest of the claimant and is not contrary to law or court order. A “qualified order” may be issued “under the authority of an applicable State statute by an applicable State court.”

To support this scheme, states have passed statutes regulating the transfer of structured settlement payments and empowering their courts to conduct transfer proceedings and issue orders that comply with federal tax law. The goals of the transfer statutes are to:

- Provide tort obligors and annuity provid-

ers certainty regarding to whom scheduled payments are to be made;

- Ensure that tort claimants are treated fairly in their efforts to sell their scheduled payments; and
- Ensure that all interested parties receive prior notification of such assignments.

Parties to a Structured Settlement

A structured settlement occurs once a structured-settlement agreement has been reached between parties, such as a claimant and a defendant. The agreement outlines the terms and compensation to be provided by the defendant or the defendant’s casualty insurer. The defendant or defendant’s casualty insurer – the party initially responsible for providing future compensation to the claimant – often will accomplish the defeasance of its obligation by purchasing an annuity contract from a third party, typically a life/annuity insurance company. The transfer of its obligation often is accomplished by a qualified assignment either directly or indirectly (through another third party) to the annuity provider. The purchase of the annuity contract traditionally is accomplished through a single premium payment. At this point, neither the defendant nor its casualty insurer has any further liability to make periodic payments to the claimant. The obligor becomes the annuity company, which then makes periodic payments to the claimant that match the periodic payments set forth in the structured settlement agreement. A simplified structured settlement transaction between a claimant and defendant is shown in **Exhibit 1**. The reader should be aware that the transfer of obligations from the defendant to the assignee need not be a qualified assignment and that assignment companies need not be subsidiaries of the annuity providers.

The Role of Factoring Companies

As a claimant’s financial situation changes over time, he or she may wish to convert the annuity payments to a single, lump-sum payment. This can be accomplished by transferring all or a portion of the structured-settlement payment rights to a third party in return for such a single payment. Factoring companies can help the tort claimant, since their business purpose is to purchase and accumulate pools of structured settlements and, in some cases, efficiently finance their activities through securitization of such pools.

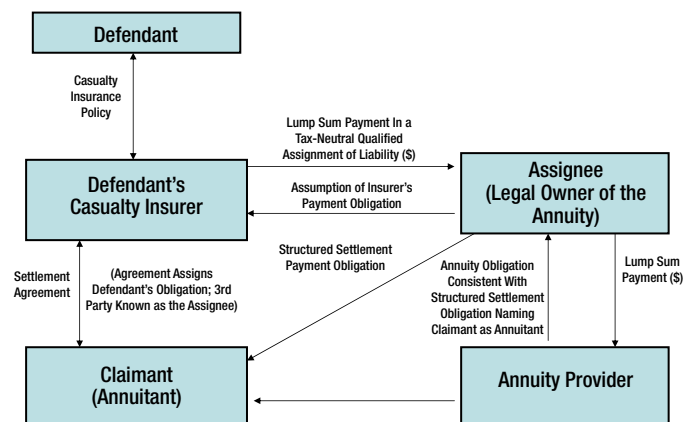
At the time of this writing, 46 states facilitate the transfers of annuity payments from claimants to factoring companies through a court-order process. Nearly all these states have transfer laws that conform to the Model State Structured Settlement Protection Act, which was agreed to by the National Structured Settlements Trade Association and the National Association of Settlement Purchasers and supported by the National Conference of Insurance Legislators (NCOIL). These transfer laws generally contain features such as:

- 1) A separate, written disclosure statement required to be given to the claimant well in advance of the closing date of the transaction.
- 2) Certification that the claimant has been advised in writing by the factoring company to seek independent, professional advice regarding the transfer, and has either received such advice or knowingly waived such advice in writing.
- 3) Notice to certain parties that may be affected by the transfer.
- 4) An itemized list of how the factoring company has calculated the present value of payments and gross amounts payable to the claimant in exchange for periodic payments.
- 5) The net amount payable to the claimant after deducting all itemized commissions, fees, costs, expenses and charges.
- 6) Court approval of the transfer, including a finding that the transfer is in the best interest of the claimant, taking into account the welfare and support of the claimant's dependents. **Exhibit 2** shows a structured settlement transaction that includes the role of the factoring companies that provide a way for claimants to monetize their annuity receipts.

Funding of Factoring Companies' Activities Through Securitization

At the time of this writing, the major factoring companies include J.G. Wentworth, Peachtree Settlement Funding and Stone Street Capital. The factoring companies fund their acquisition of annuity streams from claimants through their balance sheet or through loan facilities collateralized by the structured settlements. When enough structured settlements have been accumulated, the factoring companies can securitize them through a special-purpose vehicle (SPV), thus freeing their capital for further struc-

Exhibit 1 Basic Structured Settlement Transaction (Before Factoring)



Source: A.M. Best Co.

ured settlement activities. A.M. Best refers to the SPV as the issuer of the securities. **Exhibit 3** shows a simplified diagram for the securitization of annuity streams.

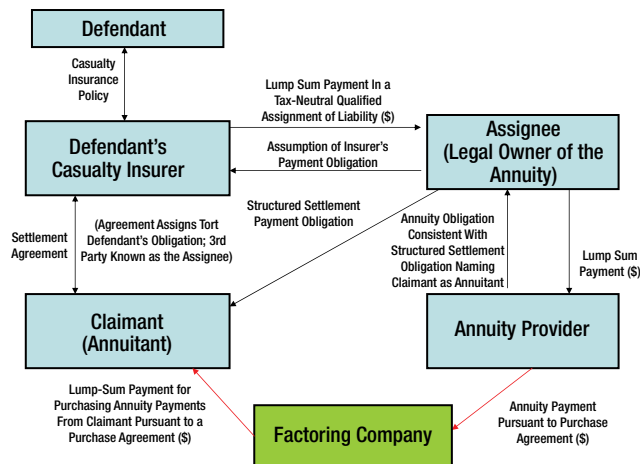
Credit Risk of Structured Settlements

Among the most important considerations for rating securities backed by structured settlements are the credit risks ascribed to the insurance companies involved in the transaction. In recent structured settlement securitization transactions, A.M. Best had financial strength ratings (FSRs) on about 95% of the insurance companies involved in the transactions. A.M. Best believes that due to its position in the insurance industry, other transactions will yield similar statistics for FSR coverage. Reports on all rated insurance companies can be found in *Best's Insurance Reports*. A.M. Best's methodologies on the quantitative evaluation of insurance companies are found, respectively, in *Understanding BCAR for Property/Casualty Insurers* and *Understanding BCAR for Life/Health Insurers* (See www.ambest.com/ratings/methodology).

Insurer Defaults

A.M. Best believes that general corporate-bond default statistics are inappropriate for assessing insurer credit risks because of the unique regulatory and accounting environment in which insurers operate, and because relatively few insurers issue public debt. As such, there are very few

Exhibit 2 Basic Structured Settlement Transaction (After Factoring)

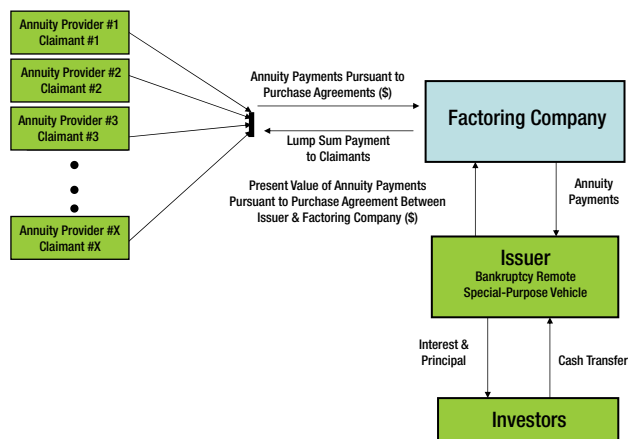


Source: A.M. Best Co.

data points available to perform a meaningful insurance default study based on the generally accepted definition of default: missed interest or principal payments on financial obligations or a bankruptcy filing. Therefore, "financial impairment" is a more measurable indication of financial duress for insurance companies.

A.M. Best designates a company as financially impaired upon the first official regulatory action taken by a state insurance department. Such actions include involuntary liquidations because of insolvency, as well as other regulatory processes such as supervision, rehabilitation, receivership, conservatorship, a cease-and-desist order, suspension, license

Exhibit 3 Simplified Securitization Diagram



Source: A.M. Best Co.

revocation, administrative order and any other action that restricts an insurance company's freedom to conduct its insurance business as normal. Companies that enter voluntary liquidation and are not under financial duress at that time are not counted as financially impaired.

It is important to note that financial impairment of insurance companies often occurs even if the companies have not been declared insolvent. For instance, an impaired company's capital and surplus could have been deemed inadequate to meet risk-based capital requirements, or there might have been regulatory concern regarding its general financial condition. Thus, at any given rating level, more insurers would be impaired, according to the A.M. Best definition, than actually would default on policyholder obligations or, perhaps, on other obligations, such as senior or subordinated debt.

Based on the definition of financial impairment, A.M. Best has conducted and continues to conduct extensive studies to determine the impairment rates of insurance operating companies. These impairment rates can serve as proxies for defaults on financial obligations made by those companies. The latest study at the time of this writing, *Best's Impairment Rate and Rating Transition Study – 1977 to 2010*, published May 16, 2011, covers more than 5,000 operating insurance companies that carried a Best's FSR from Dec. 31, 1977, to Dec. 31, 2010. In that period on average, 21.6 companies per year – or a total of 713 operating insurance companies – were designated as financially impaired. **Exhibit 4**, Best's Cumulative Average Impairment Rates, shows the one-year to 15-year cumulative average impairment rates for highly rated insurance companies in the most recent impairment study at the time of this writing. Updates to this study are posted on the A.M. Best website (www.ambest.com/research).

The reader should be aware that A.M. Best has an equivalent issuer credit rating (ICR) on the credit market scale, familiar to capital markets participants, for nearly all FSRs it issues. The translation from FSRs to ICRs is shown in **Exhibit 5**. As an example, an operating insurance company with an FSR of "A+" would have an ICR of either "aa"

or “aa-”, depending on the results of the analysis done by the rating analyst for the company in question. For more information on the translation of FSRs to ICRs, please see *A.M. Best’s Ratings and the Treatment of Debt*, published Oct. 11, 2004.

In the context of structured settlement securitization, ICRs are significant because A.M. Best’s idealized default rates for insurers (which are, in part, derived from A.M. Best’s impairment studies) are shown on the credit market scale familiar to capital market participants. **Exhibit 6** shows the idealized default rates assumed for insurance operating companies on the traditional credit market scale. The default rates on this table are applied to the insurance companies in structured settlement transactions.

Unrated Insurance Companies

If A.M. Best rates the insurance company that issues the annuity in a structured settlement, the default rate associated with that insurance company’s ICR also is used in the analysis of the securitization. If the insurance company is not rated by A.M. Best but is rated by another rating agency, the ICR assigned by that rating agency and the applicable default rate, if available, will be used in the analysis. An insurance company with no rating from any rating agencies – and not previously impaired – generally will be assigned a rating of “bb+”, the highest non-investment grade ICR issued by A.M. Best. An insurance company that has no rating from any rating agencies, and that is under regulatory supervision, will be assigned an issuer credit rating of “b.” In such cases, an exception may be made when 1) the company has continued making payments on its contract obligations for the past three years or 2) insurance regulators have expressed confidence that all policyholder obligations will be paid in full during the rehabilitation or runoff process.

Correlations

The annuity issuers in the structured settlement pools evaluated by A.M. Best usually consist of large insurance companies. Given the size of these companies, it is reasonable to assume that their default probabilities are correlated, since they tend to hold similar investment assets. A.M. Best will either assume a heightened default rate to account for default correlations or assume a default correlation of 15%.

Exhibit 4 Best’s Cumulative Average Impairment Rates*

U.S. Life/health and property/casualty data from 1977 to 2010

Financial Strength Ratings

Year	A++/A+	A/A-
1	0.06%	0.18%
2	0.18%	0.55%
3	0.33%	1.02%
4	0.49%	1.50%
5	0.64%	2.04%
6	0.86%	2.62%
7	1.09%	3.21%
8	1.33%	3.86%
9	1.63%	4.48%
10	1.95%	5.05%
11	2.28%	5.64%
12	2.71%	6.13%
13	3.17%	6.60%
14	3.63%	6.99%
15	3.97%	7.36%

*From *Best’s Impairment Rate and Rating Transition Study – 1977 to 2010*, published May 16, 2011.
Source A.M. Best Co.

Recoveries

In general, state guaranty funds cover up to \$100,000 of cumulative cash flow on annuities. Individuals with scant knowledge of the operation of guaranty funds will state categorically that policyholders do not lose money in life insurance company impairments. A more careful examination of insurance company impairments and their resolutions, however, will reveal that annuitants have a reasonable risk of diminished value of the cash flows if:

- There are delays in receiving promised cash flows or
- A new insurance company purchases the annuity book of business owned by the impaired insurance company and changes the terms of the annuity contract backing the structured settlement to the detriment of the annuitant.

For these reasons, A.M. Best applies various recovery and payment-delay scenarios gleaned from actions taken by guaranty funds and by insurance companies in impairments. A.M. Best assumes a recovery of 85% on defaults with a lag of one year.

Mortality Risk of Life-Contingent Structured Settlements

The most significant factor for evaluating life-contingent structured settlements is mortality risk – that is, the risk that claimants will die

Exhibit 5 Financial Strength Ratings & Equivalent Issuer Credit Ratings

Financial Strength Rating (Operating Insurance Company)	Equivalent Issuer Credit Rating on the Credit Market (Operating Insurance Company)
A++	aaa
A+	aa+
A	aa-
A-	a+
	a
	a-

Source: A.M. Best Co.

earlier than predicted. An earlier death means a curtailment of the annuity cash flows. A.M. Best begins its evaluation of mortality risk by looking at the underwriting criteria used by the factoring companies in purchasing structured settlement cash flows. At the time of this writing, there are no mortality tables just for structured settlements, although there are experience studies that show excess death rates of structured settlement annuitants compared with standard annuity tables.

There are generally two ways issuers can determine the life expectancies of structured settlement annuitants. The issuers can either seek the help of medical underwriters – now used extensively in the life settlement field – to estimate life expectancies, or they can use in-house underwriting expertise. Either way, the issuer’s main goal with regard to life-contingent structured settlements is to limit the types and levels of medical impairments allowed in the pool so as to manage the volatility of the claimants’ life expectancies in the transaction.

Using Independent Medical Examiners

The lack of fully developed mortality tables for structured settlement annuitants makes it necessary to put a limit on the type of medical impairments that would be allowed in the pool. One way to accomplish this is to have medical underwriters assess the mortality profile of each annuitant in a structured settlement pool to exclude those annuitants whose life expectancies have been shortened excessively by injuries that make life expectancies difficult to estimate. The life settlement industry uses medical examiners extensively, as further described below,

to assess the life expectancies of individuals who desire to sell their policies in the secondary market. The same medical examiners can be used to evaluate the life expectancy of structured settlement annuitants. The document *Life Settlement Securitization*, published Nov. 24, 2009, by A.M. Best, provides additional information about medical examiners and their general methodology.

Medical examiners use a numerical rating system developed by reinsurers to determine how an individual’s mortality differs from a “standard” risk. In general, standard risk is given a value of 100%, which represents a unit of risk. The system assigns debits and credits to a life where debits are factors that increase a person’s mortality over a standard risk and credits are factors that decrease a person’s mortality over a standard risk. For example, an individual might have coronary heart disease that may be assigned a debit of 150%, and if that person has had bypass surgery to manage the ailment, he or she may earn credits of 25%. When the debits and credits are totaled, the person has a net debit balance of 125%. If a standard risk is considered to have a table rating of 100%, then this risk relative to standard will have a rating of 225%. This can be interpreted to mean that the probability that this individual will die is 125% higher than that of a standard risk — i.e. 225% of a standard risk. The percentage rating is commonly known as a mortality rating; this individual thus is said to have a mortality rating of 225%. It is important to recognize that one of the significant tasks of a medical examiner is to determine what constitutes a standard risk, since the mortality rating is a relative measure of the probability of death, not an absolute measure. Authors Brackenridge, Croxson and Mackenzie put it succinctly in the fifth edition of *Brackenridge’s Medical Selection of Life Risks*:

The underwriting of substandard lives uses comparative mortality to judge substandard risks. Simply put, in order for a condition to be viewed as substandard, mortality observed among those people having the condition must be greater than the mortality otherwise expected. And in order to know what mortality to expect, a reference mortality experience must be available.

No matter the medical examiner, the standard risk class should represent a combination of risks that are substandard as well as risks that are above standard – not just risks of healthy individuals. To arrive at a life expectancy for most lives, the medical underwriter applies the mortality rating to its standard mortality, otherwise known as the “reference mortality experience” in the passage above. Because each medical underwriter uses its own mortality tables and has its own method of determining debits and credits to account for diseases, lifestyle and mortality improvements, it is difficult to derive a mortality curve for a given insured unless one knows the specific standard table used by that medical examiner. For this very reason, one who receives a mortality rating from a medical examiner for an insured also should get the corresponding standard mortality table that is used to derive the life expectancy; otherwise, the data set is incomplete for the purposes of analyzing mortality risk. The life settlement industry, which is one of the industries that uses medical examiners to determine life expectancies, has surmised that most medical examiners currently use the 2008 VBT as standard – a conclusion that is not entirely wrong for life settlements.

For structured settlements, however, it may be reasonable for medical examiners to modify these standard tables to 1) shorten (or perhaps eliminate) the select period so as to grade the mortality rates faster toward the population mortality rates (as is the case with annuity tables); 2) account for mortality improvements, since structured settlement annuitants are generally much younger than individuals selling their policies in the life settlements market; 3) account for the fact that there may be some self-selection for those who accept life-contingent structured settlement agreements from defendants – i.e. the claimants may accept life-contingent awards because they believe that their life expectancies are longer than those determined by defendants in tort cases; and 4) apply an additional level of conservatism (i.e. higher debits) if medical records are limited as is the case with many structured settlement cases. A.M. Best views favorably standard mortality tables that have been

Exhibit 6 Best’s Idealized Default Rate of Insurers*

Year	(On the Credit Market Scale)						
	aaa	aa+	aa	aa-	a+	a	a-
1	0.03%	0.06%	0.11%	0.16%	0.21%	0.23%	0.27%
2	0.11%	0.32%	0.44%	0.56%	0.67%	0.74%	0.89%
3	0.20%	0.58%	0.76%	0.95%	1.13%	1.25%	1.51%
4	0.31%	0.84%	1.08%	1.33%	1.58%	1.76%	2.13%
5	0.45%	1.10%	1.41%	1.71%	2.02%	2.25%	2.75%
6	0.60%	1.37%	1.73%	2.09%	2.46%	2.74%	3.37%
7	0.77%	1.64%	2.06%	2.47%	2.88%	3.21%	3.98%
8	0.96%	1.92%	2.38%	2.84%	3.31%	3.68%	4.58%
9	1.15%	2.20%	2.70%	3.21%	3.72%	4.13%	5.18%
10	1.36%	2.48%	3.03%	3.58%	4.13%	4.58%	5.76%
11	1.58%	2.76%	3.35%	3.94%	4.53%	5.01%	6.33%
12	1.81%	3.05%	3.68%	4.30%	4.92%	5.43%	6.88%
13	2.05%	3.35%	4.00%	4.65%	5.31%	5.84%	7.42%
14	2.29%	3.64%	4.32%	5.01%	5.69%	6.25%	7.93%
15	2.53%	3.94%	4.65%	5.36%	6.06%	6.64%	8.43%

*Derived from Best’s *Idealized Default Matrix* published Dec. 5, 2007.
Source: A.M. Best Co.

created with the help of qualified actuaries – especially those who are familiar with substandard annuities.

A medical examiner can provide some or all of the following information:

- Its standard mortality tables upon which debits and credits are applied.
- A mortality rating (i.e. 100% + net debits and credits) that the medical examiner applies to its base mortality table to derive the life expectancy for each annuitant.
- A life expectancy estimate for each annuitant.
- A mortality or survivorship schedule for each annuitant (given medical impairments).
- The primary disease category for each annuitant, if one has been identified.
- A report that validates the historical accuracy of the medical examiners’ life-expectancy projections (i.e. actual to expected results).

Exhibit 7 shows some of the diseases and injuries typically encountered by medical examiners in both structured settlement and life settlement transactions.

To control the severity of impairments in a structured settlement pool, A.M. Best generally will restrict the mortality rating of any annuitant to 500% or lower. If the issuer purchases the structured settlement of an annuitant with a mortality rating over 500%, A.M. Best would require additional expert opinion (preferably, an expert on the health

condition or injury suffered by the annuitant) about the life expectancy of the individual and would further stress the mortality rating (by reducing the life expectancy) for that annuitant for modeling purposes.

Using In-House Medical Underwriting

Using in-house medical underwriting as opposed to using medical examiners may be appropriate since the demographics of claimants in structured settlement transactions are quite different from those in current life settlement pools who are medically underwritten by medical examiners. For one thing, life settlements are generally for those ages 65 or older, whereas the median age of the annuitants in purchased structured settlements is around 44 years. In addition, those selling their insurance policies in the current life settlement market usually own policies with face values of \$250,000 or higher. Claimants in structured settlements, on the other hand, generally have little or no insurance, indicating that they are not as wealthy as the insureds in life settlements. Since not all medical examiners have experience in estimating the life expectancies of the types of individuals that enter structured settlements, A.M. Best generally accepts in-house medical

underwriting as long as the following information is available:

- Documented underwriting standard.
- An evaluation by actuaries of the underwriting procedures used by the issuer in evaluating the life expectancies of the claimants.
- The basic guidelines for excluding cases where it is difficult to evaluate life expectancies. For example:
 - Are claimants who take high doses of certain medications excluded?
 - Is there an interview – via phone, e-mail, or in person – associated with the evaluation process?
 - Are certain injuries, such as cerebral and spinal cord injuries, excluded?
 - Are cases where there is a permanent vegetative state (PVS) excluded?
 - Does the in-house underwriting process produce debits and credits similar to independent medical underwriters?
 - Is there a debit threshold beyond which claimants are excluded from the pool?
- The extent to which information provided by the claimants for purposes of determining mortality risk is verified.
- The methodology for creating underwriting tables used to evaluate the claimants’ life expectancy.
- Whether any annuity or population tables were used – and if not, why not.
- Circumstances under which expert opinion is sought regarding certain medical conditions for the purpose of establishing life expectancies.
- Details on how mortality improvements are included in the determination of the claimants’ life expectancy.
- Whether there is a maximum or minimum age allowed.
- The extent to which the medical records of claimants are sought and used for the underwriting process.
- Other significant information related to the underwriting of life-contingent life settlements.

Mortality Risk Mitigation

One way to manage mortality risk is through a life-contingent insurance policy that provides the issuer with supplemental cash flows until a fixed date, regardless of whether the annuitant is alive or dead. The insurer effectively assumes the risk of the annuitant’s early death. In essence, the insurer fixes the date of

Exhibit 7
Typical Impairments Seen by Medical Examiners

Injuries and Diseases	Examples
Spinal Cord	Paraplegia, Quadriplegia
Craniocerebral	Traumatic, Anoxic, other
Burns	
Birth Asphyxia/Hypoxia	
Cardiovascular	Coronary Artery Disease, Arrhythmia, Other (e.g., Heart Valve Disease)
Cancer	Lung, Prostrate, Breast, Hematological, All Other Cancers
Cerebrovascular	Stroke, Carotid Artery, Transient Ischemic Attack
Dementia	Alzheimer’s, Multi-Infarct
Respiratory Diseases	Emphysema, Asthma, Sleep Apnea, Chronic Obstructive Pulmonary Disease
Neurological Disorders (Excluding Alzheimer’s)	Parkinson’s, Lou Gehrig’s Disease (ALS)
Diabetes	
Other	Renal Failure, Peripheral Vascular, etc.

Source: A.M. Best Co.

death of the annuitant for modeling purposes. A.M. Best will review the insurance policy to ensure that 1) the policy is fully backed by a rated entity (or parent with a “cut-through” provision); 2) the obligation to pay claims does not have unreasonable loopholes whereby claims can be denied easily, and 3) the policy will not lapse easily.

A.M. Best’s considerations regarding the appropriateness of the insurer include 1) the insurer’s ICR – A.M. Best requires an ICR of at least “a-,” and 2) evidence of timeliness of payments by the insurer for covered obligations.

General Underwriting Standards Of Factoring Companies

The issuers of securities backed by structured settlements rely on the underwriting standards of the factoring companies that purchase annuities from claimants. Clean underwriting standards and strict compliance with laws of each state where the structured settlements were originated have reduced the risk of challenges to the periodic payment assignments made by claimants (and their heirs or beneficiaries) and insurance companies. While the existence of court orders before a transfer is allowed reduces the risk of such challenges, transferees still should ensure that their origination criteria consider the following issues:

- The general underwriting guidelines for purchasing the structured settlements – including the underwriting guidelines for choosing which life-contingent structured settlements to purchase;
- The possibility that the annuity cash flows could be encumbered by bankruptcy of the claimant or any liens on such cash flows;
- The possibility that the estate of the tort claimant will be challenged by a spouse, relatives and dependents of the claimant;
- Screening for income level and physical disability considerations so as not to cause undue hardship for low-income and disabled tort claimants who should maintain annuity cash flows to cover basic living and medical expenses;
- Screening for tort claimants such as minors or adults who cannot legally enter contracts; and
- The possibility that the structured settlement may affect the claimant’s eligibility for Medicaid and other programs.

Transaction Requirements, Recommendations & Expectations

The following items are requirements, recommendations and expectations for the pool of structured settlements.

- Clear underwriting standards for both period-certain and life-contingent structured settlements.
- Insurance companies issuing annuities must have a “bbb-” ICR or higher.
- Confirmation that structured settlements are pursuant to a court order.
- Present value of the structured settlements related to one insurer should not exceed 15% of the total face value of the pool – a concentration of more than 15% would result in additional stresses, although exceptions may be made for insurers with “aaa” ICRs.
- For life-contingent annuities, A.M. Best recommends:
 - At least 300 lives for the pool and
 - That a factoring company ascertain whether the claimant has had life insurance, and what size – a claimant who already has qualified for a large life insurance policy before the tort action may have a base mortality profile closer to the standard mortality tables.
- For life-contingent annuities, A.M. Best requires:
 - The periodic cash flows for each annuitant being purchased by the issuer;
 - The life expectancy and mortality ratings (based on the claimant’s medical records, if any) from at least one medical examiner for each individual if issuer does not use in-house underwriting that has been evaluated by professional actuaries or consultants (see the methodology, *Life Settlement Securitization*, published Nov. 24, 2009, for the standards for evaluating medical examiners);
 - Results of the issuer’s in-house underwriting for each claimant;
 - Details on the annuitants, including age, gender and smoking status;
 - The state in which the court order was issued for each annuitant – a concentration of more than 8% in any state would result in additional stress;
 - The issuer to get HIPAA-compliant medical release forms for each annuitant if legally mandated;
 - The mortality tables (and the adjustments) used by the factoring company

- and/or the issuer to value the structured settlements;
- The factoring company to identify and classify the physical injuries, if any, that gave rise to the tort or workers' compensation claim – such information, which is gathered from public documents, may be useful to medical examiners;
 - Clear guidelines by the collateral manager as to the types of structured settlements to include in the collateral pool – e.g., gender, age, state distributions, etc.;
 - Procedures for determining whether the annuitant is dead or alive;
 - The mortality tables assumed by the issuer in analyzing the transactions and the reasons for such tables;
 - Categorization of impairments, if any (see **Exhibit 7**); and
 - The life-contingent insurance agreement, if any, between the issuer and an insurer.
- For period-certain annuities, A.M. Best requires the periodic cash flows purchased by the issuer aggregated by each insurance company in the pool.
 - The legal name and the A.M. Best Issuer Credit Rating (ICR) for each insurance company in the pool.
 - Any historical data from the factoring companies' business, such as defaults on annuity payments, recoveries, late payments and payment errors.
 - Any historical data from the servicer on diversions.
 - Any data on mortality of structured settlements handled by the servicer.
 - Identification of a master servicer that provides the following duties (on behalf of the trustee):
 - Receiving and posting payments from annuity companies;
 - Making all payments to securitization constituents (bondholders as well as service providers);
 - Performing transaction accounting, dealing with the annuity companies in connection with administrative issues;
 - Tracking deaths; and
 - Performing analysis on the performance of the issuer's collateral pool.
 - Identification of a collateral manager that will:
 - Determine what structured settlements will be included in the securitization (particularly when considering inclusion of life-contingent structured settlements);
 - Determine what actions to take in the event decisions have to be made about the annuities after an insurance company impairment; and
 - Make other decisions regarding the servicing of the pool of structured settlements in the event the current servicer has to be replaced.
 - Identification of a backup servicer, trustee, auditors, lock box bank, legal counsel, investment banks and other service providers in the transaction.
 - Indentures and other legal documents pursuant to the transaction.

Modeling and Stress Testing

At its most basic level, A.M. Best's model uses the Monte Carlo simulation technique to generate the cash flow associated with every structured settlement after considering the appropriate credit risks of the insurance companies that have issued the annuities and, if the structured settlement is life-contingent, the appropriate mortality profiles of the annuitants.

For life-contingent structured settlements, the model draws random numbers (given the mortality profile of an annuitant) to determine when the annuitant has died. As long as the annuitant is alive, the Issuer receives the annuity payments until the end of the period in which the structured settlement annuity cash flows have been purchased by the Issuer. The payments stop when the annuitant is dead. At the same time, the model draws a random number (given the default rates of insurers) to determine whether the insurance company that issued the annuity is in default. If the insurance company goes into default before the annuitant dies, the annuity payment is missed in the year of default but resumes the next year after a 15% reduction in the annuity payments from that year until the annuitant dies. If the insurance company goes into default after the annuitant dies, the default has no effect on the cash flows to the Issuer.

For period-certain structured settlements, the model draws random numbers to determine when the insurance company that issued the annuity is in default. If the insurance company goes into default, the annuity payment

Exhibit 8

Best's Idealized Default Matrix *

Year	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-
1	0.03%	0.03%	0.04%	0.05%	0.06%	0.11%	0.16%	0.21%	0.23%	0.27%
2	0.08%	0.11%	0.13%	0.23%	0.32%	0.44%	0.56%	0.67%	0.74%	0.89%
3	0.14%	0.20%	0.26%	0.42%	0.58%	0.76%	0.95%	1.13%	1.25%	1.51%
4	0.22%	0.31%	0.41%	0.62%	0.84%	1.08%	1.33%	1.58%	1.76%	2.13%
5	0.31%	0.45%	0.58%	0.84%	1.10%	1.41%	1.71%	2.02%	2.25%	2.75%
6	0.42%	0.60%	0.79%	1.08%	1.37%	1.73%	2.09%	2.46%	2.74%	3.37%
7	0.53%	0.77%	1.01%	1.33%	1.64%	2.06%	2.47%	2.88%	3.21%	3.98%
8	0.66%	0.96%	1.25%	1.58%	1.92%	2.38%	2.84%	3.31%	3.68%	4.58%
9	0.79%	1.15%	1.51%	1.85%	2.20%	2.70%	3.21%	3.72%	4.13%	5.18%
10	0.94%	1.36%	1.79%	2.13%	2.48%	3.03%	3.58%	4.13%	4.58%	5.76%
11	1.09%	1.58%	2.08%	2.42%	2.76%	3.35%	3.94%	4.53%	5.01%	6.33%
12	1.24%	1.81%	2.38%	2.72%	3.05%	3.68%	4.30%	4.92%	5.43%	6.88%
13	1.40%	2.05%	2.69%	3.02%	3.35%	4.00%	4.65%	5.31%	5.84%	7.42%
14	1.57%	2.29%	3.01%	3.33%	3.64%	4.32%	5.01%	5.69%	6.25%	7.93%
15	1.73%	2.53%	3.34%	3.64%	3.94%	4.65%	5.36%	6.06%	6.64%	8.43%

* Table is taken from the methodology report *Best's Idealized Default Matrix*, published Dec. 5, 2007

is missed in the year of default but resumes the next year after a 15% reduction in the annuity payments.

The modeling described above is performed for a large portfolio consisting of both period-certain and life-contingent. For each trial in the simulation, the model aggregates the cash flows (annuity payments); makes payments as prescribed by the transaction's waterfall; and determines whether the net cash flows are sufficient to pay interest and principal when due. If payments are missed because of inadequate cash flow, the model records a default. The ultimate output of A.M. Best's cash flow model is the default rate – the total number of defaults for all trials divided by the number of trials. This default rate then is tied to Best's Idealized Default Matrix (**Exhibit 8**), which shows the default rates associated with debt ratings. The credit quality of the securities is based on the long-term credit rating scale, not the FSR scale.

Stress testing of key parameters is performed on the transaction to assess the impact on defaults of the securities. The parameters stressed in the modeling of the transaction

include the mortality rates, insurance carrier defaults and recovery rates.

Performing Surveillance

As part of the surveillance activities with regard to structured settlement securitizations, the information required by A.M. Best includes, but is not limited to, the following:

- The date of death of any annuitant and the date the death was reported to the issuer.
- Any insurance company impairments (i.e. insolvency, rehabilitation, cease and desist order).
- Any changes in annuity cash flows – whether due to insolvency, changes in crediting rates or other reasons.
- Reconciliation as to why the cash flows deviate from original projections.
- Payments, if any, by the insurer that is hedging the life-contingent structured settlements.
- Any violations of underwriting criteria discovered by the collateral manager, back-up servicer or other service providers.
- Periodic updates of the remaining cumulative annuity cash flows.
- Details of any defaulted/written-off annuity cash flows.

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Methodology

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