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## Analyzing Securities Issued Under the U.S. Treasury's Capital Purchase Program

Several publicly traded insurers have announced plans to apply for funds through the U.S. Treasury Department's Capital Purchase Program (CPP). Considering the interest from insurers rated by A.M. Best in obtaining access to this capital, A.M. Best will rate these issues and determine equity credit using standard rating methodologies.

To be eligible to participate in the CPP, several insurers have sought approval to become savings and loan holding companies or bank holding companies through applications with the Office of Thrift Supervision (OTS) or the Federal Reserve, respectively. Other insurers that already own federally regulated savings bank subsidiaries would be eligible for participation in the CPP.

Should insurers be able to avail themselves of funds through the Treasury's CPP, A.M. Best will treat these securities as intermediate term in nature and not as permanent capital. A.M. Best has made this determination primarily because of the significant increase in the dividend rate after the fifth year, certain operating restrictions imposed by the federal government and the potential refinancing risk insurers may face because of the preferred shares' callable features.

The Treasury Department announced the \$250 billion Capital Purchase Program (CPP) on Oct. 14, 2008. As much as \$125 billion of the available capital went to nine of the nation's largest financial institutions that initially agreed to take part in the program. The deadline for publicly traded financial institutions to submit applications to the Treasury was Nov. 14.

At the time, the CPP represented a shift from the Treasury Department's initial focus on purchasing distressed and poorly performing assets from banks under the \$700 billion Troubled Asset Relief Program (TARP) that is part of the Emergency Economic Stabilization Act (EESA) signed into law Oct. 3. The Treasury Department wanted to quickly deploy the first \$350 billion of TARP funds authorized by Congress to unlock frozen credit markets and strengthen banks' balance sheets as conditions in financial markets deteriorated in October. (In January, the Senate approved the release of the remaining TARP funds.)

### Credit for Preferred Shares Issued Under the Capital Purchase Program

- Senior preferreds considered hybrids because of equity-like characteristics.
- Eligible for equity credit up to 50% in financial leverage calculation.
- Equity credit cap for hybrids is 20% of total capital.
- A.M. Best expects actual equity credit to fall close to 25% because of call feature and step-up in dividend rate after year five.
- Actual equity credit determined by securities' impact on holding company and insurer financial statements.

Source: A.M. Best Co.



To be eligible for CPP funds, several life insurance companies applied with federal banking regulators to change their holding company structures in conjunction with their applications to participate in the program. The Office of Thrift Supervision in January approved applications by Hartford Financial Services Group Inc. and Lincoln National Corp. to purchase savings and loans and convert to thrift holding companies. The Federal Reserve also approved Protective Life Corp.'s application to become a bank holding company in association with its purchase of a Florida-based bank holding company and its subsidiary.

Genworth Financial Inc. and Phoenix Cos. also have applications pending with federal banking regulators. These insurers also agreed to purchase savings and loans or bank holding companies, pending approval of their applications for banking charters and participation in the CPP. In addition, Principal Financial Group Inc. disclosed in November that it had applied for as much as \$2 billion in funds through the CPP, while Prudential Financial Inc. confirmed in December that it had applied for funds under the CPP.

Dutch insurer Aegon N.V., the parent of Transamerica Life Insurance Co., also had applied for funds in November. However, Aegon said in mid-December that it had withdrawn its application for CPP funds, as well as its application with the OTS for a thrift charter.

The Treasury Department extended the program on Nov. 17 to privately held bank holding companies and savings and loan holding companies with an application

deadline of Dec. 8. In January, the Treasury also established purchase and eligibility guidelines for other financial institutions such as S Corporations. The Treasury's investments in S Corporations will take the form of subordinated debt rather than preferred stock to preserve these financial institutions' status under tax laws. It is not clear whether the Treasury plans to allow other institutions such as mutual depository institutions to participate in the CPP and whether any guidelines would extend to insurers organized as mutual holding companies.

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### Treasury Department – Capital Purchase Program

- Treasury to purchase up to \$250 billion of senior preferred shares.
- Rank is Tier 1, same as existing preferreds.
- Value of shares may range from 1% to 3% of bank's risk-weighted assets up to \$25 billion.
- Dividend rate of 5% first five years; step up to 9% after year five.
- Callable at par after three years; early through perpetual preferred stock or common stock offerings.
- Restrictions on dividends and share buyback programs.
- Senior preferreds can be transferred to third parties at any time.
- Treasury also holds warrants to buy common shares of up to 15% of investment; these are also marketable

Source: Treasury Department

Through December 2008, Treasury had purchased or committed to purchase preferred shares in 215 institutions for a total of more than \$187.5 billion under the CPP. Since the announcement of the CPP, the Treasury Department has employed a number of other strategies for using the remaining TARP funds. (See “TARP Evolves as Treasury Responds to the Financial Crisis”, page 4.)

### Rating Perspective

For those insurers choosing to participate, A.M. Best expects them to be subject to terms and issue limits similar to those previously announced for banks. New securities issued under the CPP consist of senior preferred shares and warrants to purchase common shares. The subscription amounts available to banks range from 1% to 3% of risk-weighted assets, to a maximum of \$25 billion.

Dividend interest is not tax deductible by the issuer. Additionally, the shares are callable at par after three years or may be redeemed early through the issuance of perpetual preferred stock or common stock. However, after year three, there are no restrictions on the type of security that could be issued.

Given these features, A.M. Best views these securities as intermediate-term in nature and not permanent, particularly given the increase in the dividend rate and certain operating restrictions to be imposed by the government. Moreover, A.M. Best believes the medium-term nature of these securities exposes insurers to refinancing or repayment risk.

A.M. Best will assign ratings to these securities using standard rating methodologies, as these securities will be marketable based on the Treasury’s right to transfer them to third parties. Additionally, A.M. Best will review each security on its own merits, including a review of the intended use of the proceeds and the terms of the issuance, which are likely to be substantially similar for all issuers.

The senior preferreds are considered a hybrid security because of their equity-like characteristics. These securities may be eligible for equity credit of as much as 50% in the organization’s financial leverage

calculation, with equity credit for hybrids subject to a cap of 20% of total capital. A.M. Best expects actual equity credit to fall closer to 25% in most cases because of the call feature and significant step-up in the dividend rate after year five. The actual equity credit will be determined by the securities’ impact on the holding company and insurer financial statements, and they will be reviewed on a case-by-case basis.

Given the restrictions on these issues, A.M. Best expects these securities to be replaced or redeemed when markets stabilize – within at least three to five years. In the near term, any increase in financial leverage will be reviewed relative to the issuer’s financial flexibility. Insurance companies’ participation in the CPP, with access to low-cost funding, minimizes but does not alleviate concerns regarding financial flexibility.

The treatment above is subject to change, as the structure of the program appears fluid. A.M. Best notes that accessing the CPP adds regulatory oversight to insurers by meeting the bank/thrift ownership requirement. Overall, A.M. Best believes that having access to government funds is prudent, given the current turmoil in the capital markets. However, the features of the securities partially mitigate the positive impact on ratings.

If A.M. Best believes that accessing CPP funds will satisfy an insurer’s short-term liquidity needs, and if operating fundamentals are sound, A.M. Best would view favorably the use of proceeds to bolster the capital position of the insurance companies through direct capital contributions or the use of surplus notes. If A.M. Best believes the funds would be used as a stopgap measure to support a stressed capital position, the impact would be less favorable. Additionally, A.M. Best would evaluate the impact on the organization’s risk profile of other potential uses of proceeds, such as acquisitions or investments in high-risk asset classes.

Additionally, the limitations on management – including dividend restrictions and executive compensation – are intended to facilitate prudent decision-making for the organization. A.M. Best believes

the strategies implemented potentially will foster the organic growth of capital necessary to replace or redeem these issues.

### Conclusion

A.M. Best expects life insurers to be the major insurance participants in the CPP. Currently, A.M. Best maintains a negative rating outlook for the U.S. life insurance industry. While fundamentals for the vast majority of life/health companies remain sound, uncertainty regarding the economy, real estate values, interest rates,

equity markets – both domestic and global – and liquidity will impact life/health insurers' balance sheet strength and operating performance in the near term.

While A.M. Best typically does not react to short-term volatility, large reductions in capital or earnings will be viewed negatively, given the magnitude of uncertainty and rising risks in the capital markets. Finally, A.M. Best will continue to evaluate each company's performance on an individual basis and react accordingly.

## TARP Evolves as Treasury Responds to the Financial Crisis

The Treasury's implementation of the Troubled Asset Relief Program (TARP) continues to evolve. After an initial focus on purchasing poorly performing mortgage-related assets when the EESA was signed into law in early October, Treasury officials' current priorities for the remaining TARP funds are expected to be allocated toward consumer lending and prevention of foreclosures. Along the way, the Treasury Department has continued to use TARP funds to strengthen ailing financial institutions.

Outside of the Capital Purchase Program (CPP), for example, the Treasury Department purchased \$40 billion of senior preferred stock with warrants from American International Group Inc. as part of the federal government's restructuring of assistance to AIG announced on Nov. 10. Unlike the CPP, the preferred shares issued by AIG have a 10% annual dividend rate. The Treasury invested in AIG as part of the Systemically Significant Failing Institution (SSFI) program under TARP.

A further use of TARP funds occurred with the announcement on Nov. 23 that the Treasury would invest \$20 billion in Citigroup Inc. in exchange for preferred securities with an annual dividend of 8%. (Citigroup already had sold \$25 billion in preferred shares to the Treasury under the CPP in a transaction that closed in late October.)

Treasury also committed as much as \$5 billion of TARP funds as part of a loss-sharing agreement with the Federal Deposit Insurance Corp. (FDIC), the Federal Reserve and Citigroup on an asset pool of \$301 billion of loans and securities primarily backed by

commercial and residential real estate. As a fee for the asset-pool guarantees, Citigroup is issuing another \$4 billion of preferred shares to the Treasury and \$3 billion to the FDIC at an annual dividend rate of 8%.

Although the Citigroup transaction displayed some aspects of TARP's intent, such as backstopping mortgage-related assets, the Treasury Department had stated publicly earlier in November that it would focus on other initiatives with the remaining TARP funds. In a Nov. 12 speech, Treasury Secretary Henry M. Paulson said that purchasing illiquid mortgage-related assets would not be the most effective way to use TARP funds at the time. Paulson noted that the department would continue to examine whether targeted asset purchases could play a role in strengthening the financial system and supporting lending, however.

Since then, the Treasury has focused on consumer-related initiatives. A portion of TARP funds is expected to go toward mortgage-loan modifications, though specific guidelines have yet to be determined. Meanwhile, the Treasury is providing \$20 billion of TARP funds for credit protection to the Federal Reserve in connection with the Term Asset-Backed Securities Loan Facility (TALF) announced on Nov. 25.

The TALF seeks to aid liquidity in the asset-backed securities (ABS) market through as much as \$200 billion of loans by the Federal Reserve Bank of New York. The loans are secured by newly-issued, AAA-rated ABS backed by new and recently originated automobile, student or credit card loans, as well as small business loans.



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