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A.M. Best's Liquidity Model
For U.S. Life Insurers**Rating Analysts**Stefan Holzberger, Assistant Vice President
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Stefan.Holzberger@ambest.com**Rating Commercial Paper**

Commercial paper is defined as a short-term, unsecured promissory note, generally issued for the purpose of meeting current liquidity needs. The fixed term can range from one to 270 days, with the majority of commercial paper issued at a maturity of 30 days or less. Because commercial paper is backed only by confidence in the issuer's promise to pay, only firms with widely recognized credit strengths are able to sell commercial paper in the money market at a reasonable price. A.M. Best's analytical process for commercial paper includes an analysis of a company's capacity to generate cash – including an assessment of the variety, availability and stability of alternative sources of liquidity – to service its short-term obligations. The analysis focuses on all short-term debt obligations, i.e. those with a term of one year or less.

A.M. Best's analysis of short-term creditworthiness includes a careful assessment of operating cash flow and the availability of other assets; the issuer's liability structure, such as the maturity schedule for short-term and other obligations; and the correlation to market risk. The purpose of the liquidity analysis is to compare the funding needs of all obligations likely to come due over the short term with probable near-term cash resources. In this evaluation, outstanding commercial paper is a component of near-term obligations, while committed bank credit facilities are viewed as a component of accessible near-term sources of cash.

The short maturities of commercial paper programs imply special risks and greater urgency in responding to rapid changes in economic conditions. As events during 2008 and 2009 have illustrated, sudden declines in operating performance and deterioration in the credit markets can lead to bankruptcy or distressed restructurings of commercial paper issuers, regardless of historical market share, profitability or financial leverage.

A.M. Best's analysis applies both qualitative and quantitative factors in determining sources used to protect an insurer's liquidity needs. An issuer-by-issuer approach is vital, entailing a careful review of sources and uses of liquidity; near-term market conditions; and contingency plans in the event of adverse events.

While commercial paper may have an initial maturity as long as 270 days, many issuers utilize the 30-day-and-under maturity range. Due to the short maturity of this security, issuers continually must refinance a significant amount of maturing commercial paper. An individual issuer may repay maturing paper with funds generated from operations or from alternative sources of liquidity. However, the bulk of maturing paper is repaid through the sale of new paper (i.e. the issuer rolls the maturing paper).

The constant need to refinance creates a risk for both the issuer and the investor. As previously noted, an adverse turn of events may make it extremely expensive, if not impossible, for the issuer to roll maturing paper. To reduce the risk to the investor, issuers

This methodology is available at
www.ambest.com/ratings/methodology

support their commercial paper programs with committed bank lines of credit. However, the supply of traditional bank credit facilities can ebb and flow with the credit markets and financial conditions of even the largest banks.

A.M. Best's analysis of overall liquidity risk incorporates all near-term claims on cash, both direct and contingent, for all entities within a group, whether or not they use commercial paper financing. A detailed quantitative and qualitative review at the issuer level of sources and uses of liquidity, market conditions and contingency plans is necessary, since an issuer's ability to generate immediate and near-term cash flow can vary significantly among industry sectors and from company to company. In addition, sources and requirements for short-term cash flow in a normal or stressful business environment can deteriorate substantially. The global financial crisis of 2008/2009 is a prime example of how operating cash flows and available credit can change quickly during times of stress.

Properly understanding relevant issues, such as the short-term funding risk of an insurer, requires an in-depth dialogue between the A.M. Best analyst and senior management of the rated entity.

Methodology

A.M. Best's ratings of commercial paper provide an opinion of an issuer's ability to meet short-term financial obligations to security holders when due. In A.M. Best's view, the inability or unwillingness of an issuer to repay a commercial paper note in full on the due date constitutes a default.

In evaluating an issuer's liquidity risk, the issuer's potential near-term obligations are considered and compared with all likely near-term sources of cash. The analysis of an issuer's short-term creditworthiness begins with a careful assessment of its liability structure, including the array of maturing obligations over the short term, the maturity profile of invested assets, and the exposure of the assets and liabilities to market risk. The purpose of the assessment is to determine the magnitude of commercial paper and other potential short-term obligations that the company's

alternative liquidity arrangements may be required to fund. Outstanding commercial paper is a component of near-term obligations, while bank credit facilities are viewed as a component of the potential near-term sources of cash.

Issuer Analysis

A.M. Best's analysis begins with a critical evaluation of an insurer's sources and uses of cash. To assess the company's ability to meet both operating needs and debt obligations, a variety of plausible stress scenarios then are analyzed. Next, contingency funding plans for a sustained period

A.M. Best Company Methodology

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of stress, caused by either company-specific concerns or general disruption in the market, are examined. General disruptions could be caused by large catastrophe claims following an earthquake or hurricane; by a “run on the bank” following a credit event; or by declines in investment portfolios due to volatile securities markets.

Tight credit conditions can create difficulties for issuers at all rating levels. In a recessionary environment in which market downturns can exceed the most severe downside projections, A.M. Best anticipates that virtually all commercial paper programs will be backed by committed bank lines of credit or other, alternative sources of liquidity.

In instances where the commercial paper program exceeds committed backup, A.M. Best must be highly confident that sufficient alternative sources of liquidity would be available in a stress scenario. These instances usually occur with larger, highly rated issuers that have considerable financial flexibility. In these cases, analytical principles that are emphasized include the matching of cash flows for short-term assets and liabilities; the quality of assets with intrinsically high cash flows; and the availability of financial and other assets that can be monetized quickly at close to par. In the case of government support in an emergency situation, A.M. Best also will factor this source of liquidity into its analysis.

A.M. Best notes that property and casualty risk characteristics are largely uncorrelated with market risk, as short-term concerns over liquidity likely would be triggered by a catastrophe loss event. Life insurance companies, particularly annuity writers, have a higher correlation with market movements, as their products carry investment and interest-rate risks. In either case, the ability to readily access short-term funding is crucial in determining a company’s short-term debt rating.

Liquidity Analysis

The starting point in liquidity analysis is assessing an insurer’s potential internal and external liquidity. Although there have been few defaults among rated commercial paper issuers, an adverse turn of events might make it extremely expensive or even impossible for the issuer to roll over

maturing paper. In addition, a company in distress quickly could lose access to external sources of liquidity, such as committed bank lines of credit, by violating covenants in the credit agreement. The purpose of the analysis is for A.M. Best to become comfortable that the issuer can smoothly accommodate the loss of confidence-sensitive funding under stress conditions without disrupting its basic business plan.

Therefore, a thorough understanding of each issuer’s liquidity profile should be considered in the context of immediacy, quality and diversity. The following depicts, at a high level, the elements of A.M. Best’s liquidity analysis.

- Discuss topics such as management’s philosophy with regard to liquidity and financial flexibility and how the short-term borrowings fit into an insurer’s overall funding strategies.
- Determine the minimum cash position.
- Evaluate operating cash flow and the degree of volatility of operations.
- Determine all short-term sources of financing available to the issuer and review all short-term funding agreements such as commercial paper programs, master note programs, money market bank loans and asset-securitization facilities.
- Evaluate the degree of dependence on and sources of liquidity.
- Consider the loyalty and financial strength of banking relationships and other backup arrangements, and review associated documents.
- Determine overall financial leverage and the ability to repay short-term debt with long-term obligations.
- Discuss stress scenarios and contingency plans should commercial paper and similar funding suddenly become unavailable.

Internal Sources of Liquidity

Cash on Hand

In evaluating an insurer’s cash on hand, A.M. Best considers:

- Currencies in which an insurer invests.
- Possible complications related to cross border repatriation, currency conversion, tax issues, regulatory concerns and sovereign risks.

Near-Term Cash Resources

In evaluating an insurer's near-term cash resources, A.M. Best considers:

- Liquidity of the investment portfolio by investment type.
- Operating cash flow.
- Dividend capacity of subsidiaries.
- Timing for conversion to cash/immediacy of availability.
- Possible value implications for liquidation in a stress situation (i.e. mark-to-market).
- Strength and availability of cash flows.
- Assets that may be pledged already or assets with springing liens.

External Sources of Liquidity

Bank Credit Facilities

In assessing an insurer's bank credit facilities, A.M. Best considers both quantity and quality. Uncommitted credit facilities, bilateral lines of credit or facilities syndicated with very few banks may be more risky when the banking system is stressed. High levels of participation in a syndicated credit facility could lead to majority control by a few banks. This could work against a company in stressful situations when amendments or waivers are required to avoid default. However, in practical terms it may be easier to negotiate an amendment/waiver with fewer lenders than with more. The analysis also considers the financial strength of the lenders and relationship factors.

Borrowing options should include same-day funding, as adverse markets may cause the company to suddenly need same-day funds to roll over maturing commercial paper. Alternative liquidity is examined to ensure that swing lines – portions of a credit facility that can be accessed on very

short notice – are available for immediate coverage on commercial paper issued in each paying agent city. A.M. Best seeks to become comfortable that the company has sufficient immediate liquidity to repay all commercial paper that comes due on any given day.

Documentation of credit facilities is reviewed carefully to determine how much flexibility a company is allowed within the provisions. These include:

- Covenants
- Material adverse change (MAC) clauses
- Events of default
- Cross-default and cross-acceleration provisions
- Maturity date
- Conditions of funding
- Changes in control or management
- Renewal procedures for multiyear or 364-day revolving credits.

Due consideration is given to contractually committed bank lines compared with an uncommitted credit facility such as advised and/or guidance facilities, which can be withdrawn by the lender at will. A.M. Best also places greater value on relationship-based, committed bank facilities than on transactional or arms-length arrangements.

Letters of Credit

While not prevalent among insurers, companies occasionally may enhance their liquidity by issuing commercial paper backed by a letter of credit (LOC) from a bank. To provide true liquidity, the LOC has to be an irrevocable and unconditional guarantee that will pay off all commercial paper at maturity in all cases. However, while the LOC provides current liquidity to the company, the bank – not the issuer – bears credit risk. In such cases, A.M. Best may rate the commercial paper program higher than the stand-alone debt rating because of credit enhancement from a bank of stronger credit quality.

Evaluating Cash Outflows

The analysis first considers the cash resources available to meet maturing commercial paper, particularly at peak borrowing periods. Then the analysis lists forthcoming claims on cash, including operating uses of cash; the maturity profile for servicing debt and other financial claims; claims that could become payable at the option of the creditor; and reasonably possible contingencies. A.M. Best has observed that management often is reluctant to reduce cash outflows for share repurchases and dividends, even in periods of increasing financial stress.

Potential Near-Term Claims on Cash Direct Obligations

- Short-term debt
- Current portion of long-term debt
- Capitalized lease obligations
- Contingent obligations
- Funding arrangements
- Financial and commodity derivatives contracts
- Off-balance-sheet financing obligations
- Litigation or judgments
- Margin requirements

Other Claims on Cash

- Working capital
- Capital spending commitments
- Stock buyback
- Dividends

Ongoing Monitoring And Surveillance

On a quarterly basis, A.M. Best requests and reviews a reconciliation of key ratios and triggers from the bank credit facility covenants. In addition, A.M. Best requests information on the authorized and outstanding amounts of the issuer's commercial paper program, and details on the backup facility coverage, including a listing of institutions providing backup facilities and the type of facility used.

A.M. Best's Commercial Paper Rating Scale

The evaluation of an issuer's commercial paper reflects A.M. Best's opinion of the issuer's overall credit quality. As a result, the analytical approach is very similar to that of assigning a long-term rating. However, the long-term rating will not fully determine a commercial paper rating because of the overlap in rating categories. In these cases, further testing of liquidity and cash flows, together with other short-term credit-quality metrics, is necessary. **Exhibit 1** shows the linkage between a short-term and a long-term rating.

AMB-1+

Cash, liquid assets and alternative sources of liquidity should be superior. Issuers accorded an AMB-1+ rating are distinguished by an exceptional ability to repay short-term debt obligations. Characteristics of this rating category include exceptional capital management, as well as significant liquidity and financial flexibility. Management's strategy ensures strong earnings and sustainable operating trends. Financial management is conservative, with low debt-to-capital and excellent fixed-charge coverage ratios. Significant liquidity is available internally from a diverse earnings base, as well as from excess cash available on the company's balance sheet. External sources of liquidity include committed

Exhibit 1

Short-Term Rating Matrix

Financial Strength Rating	Issuer Credit Rating	Short-Term Ratings			
A++	aaa	AMB-1+			
	aa+				
A+	aa				
	aa-				
A	a+		AMB-1		
	a				
A-	a-				
B++	bbb+			AMB-2	
	bbb				
B+	bbb-				AMB-3
B	bb+				
	bb				
B-	bb-				
C++	b+				
	b				
C+	b-				
C	ccc+				AMB-4
	ccc				
C-	ccc-				
	cc				
D	c				
E/F	rs				

Source: A.M. Best Co.

bank lines of credit and access to cash through the capital markets.

AMB-1

Cash, liquid assets and alternative sources of liquidity should be excellent. Issuers rated AMB-1 exhibit a strong ability to repay short-term debt obligations. Most credit issues discussed in AMB-1+ will be similar to AMB-1, with slightly lesser strengths. Issuers in this rating category will have a strong capability to service short-term debt. Fixed-charge coverage, liquidity and capital structure also are favorable. The issuer displays ready access to the capital markets and has significant alternative liquidity available to repay short-term debt obligations.

AMB-2

Cash, liquid assets and alternative sources of liquidity should be good. Issuers rated AMB-2 exhibit an acceptable ability to repay

short-term debt obligations. While alternative liquidity remains adequate, companies in this category have more variability in earnings, cash flow and fixed-charge coverage. Companies at this rating level may not be able to rely consistently on the capital markets to fulfill liquidity needs. However, they maintain adequate alternative liquidity protection.

AMB-3

Cash, liquid assets and alternative sources of liquidity are deemed to be fair. However, these measures are prone to negative volatility due to market events. Even during favorable credit market conditions, investors' interest in this paper would be very limited.

AMB-4

Correlates to the non-investment-grade, long-term rating category. The commercial paper market will not accept issuers with this rating.



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