A.M. BEST

METHODOLOGY APRIL 4, 2005

Equity Credit for Hybrid Securities

In recent years, the issuance of nontraditional debt securities within the insurance industry has expanded dramatically. The increased use of these types of securities reflects, in part, the generally more favorable treatment they receive in the analysis of an issuer's capital structure by regulators and rating agencies.

The more favorable treatment of hybrid securities relative to traditional debt instruments is principally due to the existence of equity-like features or characteristics. Many of these instruments also provide a lower after-tax cost of capital to the issuer, while at the same time they are a less expensive form of accessing capital through the equity markets.

Increasingly, market participants are asking for guidance as to A.M. Best Co.'s perspective on hybrid securities and the amount of equity benefit that may be forthcoming to an organization's capital structure in the rating process. This methodology summarizes A.M. Best's treatment of equity credit for hybrid securities issued by insurance-related entities and highlights the importance of debt-service capabilities. The assessment focuses on these instruments' use within an entity's capital structure and their impact on financial ratios and the financial flexibility of the entity issuing the hybrid security. The methodology should be read in conjunction with A.M. Best's Ratings & the Treatment of Debt methodology, available at *www.ambest.com/ratings/methodology*.

Hybrid securities, typically in the form of a preferred stock, trust preferred or convertible security, share basic characteristics associated with common equity. Hybrids can include a variety of features that, over time, allow them to exhibit changing proportions of debt and equity characteristics.

Equity Characteristics

- Long maturity (equity has no maturity);

- Ability to defer interest or dividend payments (equity has no ongoing financial commitments); and

- Subordination in an issuer's capital structure (loss protection provided to senior creditors).

Equity Credit Treatment

Conventional balance sheet treatment of certain types of securities by the accounting profession often does not represent a true picture of the risk or financial leverage employed by an organization. For instance, an issuer may have a large portion of reported equity in the form of traditional preferred stock, which has a relatively short duration to maturity. Conversely, an issuer may report a relatively large debt issue on its balance sheet that can and will be converted to common equity over a short period of time. The former is potentially exposed to a major credit event, while the latter ultimately will result in improved financial flexibility.

Accordingly, A.M. Best analyzes the features and characteristics of all securities within an issuer's capital structure and may adjust reported balance sheet financial leverage by giving, or possibly removing, equity credit to certain instruments.

Senior management of an organization often focuses on the equity credit that hybrids can receive in financial leverage calculations used in the rating process. A.M. Best considers numerous factors including, from a senior creditor's standpoint, the loss protection such securities may provide and the favorable impact that the ability to defer cash payments on these securities may have on an organization's ability to service all obligations or to fund internal growth.

While financial leverage remains a critical consideration during the rating process, A.M. Best believes that the effect of hybrid securities on debt-service ability is also a key determinant of debt capacity. In addition to the positive impact these securities may have on operating cash flow, cash coverage also can be tempered or strengthened materially by a company's consistency and sustainability of earnings and alternate sources of cash, including cash at the parent holding company level and unrestricted dividends from subsidiaries. It is important to note the interaction between financial leverage in rating analysis and capital adequacy to support all ratings within an organization. For more information regarding risk-based capital and its influence on ratings, please refer to A.M. Best's methodologies, Understanding BCAR for Life/Health Insurers and Understanding BCAR for Property/Casualty at *www.ambest.com/ratings/methodology.*

Rating Methodology

When assessing a specific entity's capital structure, A.M. Best analysts review the company's history in managing its overall capital base, its funding needs and the sources and types of financing used to satisfy its capital requirements. Integral to the overall rating process is having an in-depth understanding of management's historical and current strategies toward maintaining appropriate levels of capitalization and the structure of its capital base going forward. This understanding is of particular importance when attempting to quantify equity credit for hybrid securities, and in making assessments as to what form of capital may be present in the future and as to the permanency of that capital. For example, a company may be highly focused on maintaining or improving general measures of operating performance such as earnings per share and return on common equity. In such cases, the company may be unwilling to tolerate the dilution caused by the conversion of a security into common shares and could issue new securities to fund a share repurchase, with no assurance the new issues would not stand equally with senior creditors.

In general, A.M. Best grants equity credit, comprising up to 20% of a firm's total capital, for hybrid securities that exhibit the characteristics of common equity. The amount of credit given to hybrid securities is based on A.M. Best's belief that the insurance industry, as well as the broader financial services sector, is very sensitive to changes in the market's perception of an issuer's financial health. This sensitivity may expose issuers to sudden changes in the cost of capital or a diminished ability to access the capital markets in general. As such, A.M. Best takes a conservative view toward the amount of equity credit an individual security may receive, as well as the aggregate credit an issuer may receive. Additionally, while A.M. Best calculates coverage ratios assuming that the issuer exercises its option to defer interest or dividend payments on hybrids, the major portion of the analysis remains on calculated coverage levels including hybrid obligations.

As a general guideline, holding companies with financial leverage ratios less than 35% are considered to have an acceptable level of debt and hybrids for "a-" or higher issuer credit ratings; the 35%-to-less-than-45% range is considered accetable for issuer credit ratings in the "bbb" category; and leverage ratios greater than 45% acceptable for ICRS of "bb" and below.

Best's Equity-Debt Continuum

The equity-debt continuum is the starting point in A.M. Best's analysis of a hybrid's equity credit. The focus of the continuum is on the features of a particular security and the amount of equity credit it may receive. The equity-debt continuum summarizes A.M. Best's perspective on how debt-like or equity-like a given hybrid security is based on seniority, maturity and the cash-flow flexibility provided by its terms and features.

A.M. Best Co.

Methodology

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In ranking equity-credit-afforded securities along the continuum, A.M. Best places straight debt and securities with a cash put option at one end and both common stock and perpetual preferred securities at the other end. All other securities fall in between, based on loss-absorption characteristics and their cash-flow flexibility. The placement of securities shown here reflects A.M. Best's typical perspective, though rating committees have flexibility to adjust equity credit attribution based on individual circumstances.

Best's Equity-Debt Continuum

Equity	100%	75%	50%	25%	0%	
	0%	25%	50%	75%	100%	Debt

Classes of Hybrid Securities

The determination of equity credit for any given security is based on that instrument's specific features when compared/contrasted with the characteristics of equity: no maturity, no ongoing payments and deep subordination.

Below is a brief overview of the major classes of hybrid securities from the context of features that typically warrant equity credit.

Traditional Preferred Stock

Generally viewed as the original form of a hybrid security, preferred stock pays a stated dividend yield, much like the interest rate paid on bonds, but is unlike common stock in that it typically does not confer voting rights. Holders of preferred stock also have certain preferences or priorities over holders of common stock as to dividends and/or distribution of assets in the event of bankruptcy or liquidation.

Preferred stock is issued directly by a holding company or operating company and can include equity-like features such as:

- Perpetual maturity issues, with no put options that present refinancing or repayment risk;
- Ongoing payments can be deferred; and
- Deep subordination, senior only to common stock.

While some forms of preferred stock may receive nearly full equity credit, such as a perpetual noncumulative issue, other forms may not receive any equity credit. For example, issues with a stated duration and a short time to maturity expose the issuer to refinancing or repayment risk. The issuer also may elect to replace these deeply subordinated obligations with securities having a more senior claim in the overall capital structure. Also, for lower-rated companies, there is a risk that the organization may not be able to issue new securities to repay maturing issues.

Convertible Securities

Convertible securities typically can be converted into shares of a company's common stock. For this reason, the issuance of convertible securities typically is seen as management's readiness to issue equity in the future. In general, these instruments can be grouped into two broad categories: mandatory conversion and optional conversion.

In a traditional, mandatorily convertible security, the conversion formula is fixed; that is, the instrument automatically converts upon maturity into common stock based on a fixed price. Such instruments are equity-like since there is no obligation to return cash to investors at maturity. Furthermore, equity benefit increases progressively as maturity approaches, particularly if it is clear that the equity will remain a permanent part of the issuer's capital base. In such cases, these securities may receive up to 100% equity credit within two years of conversion. Securities with a floating exchange rate are

Typical Holding Company Financial Leverage and Interest Coverage Guidelines

Issuer Credit Rating Category	Debt*/ Capital	Interest Coverage**
aaa	<15%	>10X
aa	<25	>7X
a	<35	>5X
bbb	<45	>3X
bb	<65	>2X
b	>65	<2X

* Long-Term + Short-Term Debt (adjusted for hybrid securities)/[Total Shareholder's Equity + Minority Interest and Other + Preferred Stock (Non-Equity) + Long-Term Debt + Short-Term Debt – Unrealized Gain (Loss) on Securities]
** (Pretax Operating Income + Interest Expense)/(Interest Expense + Preferred Dividends)
As part of its overall capital analysis, A.M. Best reviews the terms and conditions of securities issued, the maturity schedule of the capital structure, and the level of goodwill, value in force, deferred acquisition costs and other intangible assets relative to reported equity and total capitalization. The level of intangible assets is of particular importance when such items constitute a significant portion of an organization's capital base, thereby distorting financial leverage ratios.
Within this analysis, A.M. Best also reviews the composition of the capital base as stated on an organization's balance sheet and may limit qualifying for various rating categories based on (Unadjusted Debt + All Preferred Securities)/Capital.

viewed as more debt-like.

Other variations of mandatorily convertible securities include those that convert to a:

• Fixed number of common shares when issued, which protects the issuer from potential earnings per share dilution; and

• Number of shares that equals the principal amount owed to the investor, which may expose the issuer to significant earnings per share dilution should its stock price become depressed prior to or at the time of maturity.

In general, a convertible security issue allows the issuer to benefit by offering lower dividend or interest rates, which enhances the issuer's fixed-charge coverage ratio.

Typically, optionally convertible securities can convert to a fixed number of common shares at the option of the investor. When reviewing such issues for potential equity credit treatment, A.M. Best looks for provisions to include an issuer's call feature, exercisable after a given time period, to require investors to convert. Without the call feature, it is unlikely that investors would forego the benefit of continuing to receive dividend payments on "in the money" securities.

Key features of optionally convertible securities typically include:

• Maturity—Its automatic conversion to common shares from issue makes it closely resemble common equity's no-maturity characteristic, but while these securities typically do not have a repayment issue, they represent a subordinated claim in the event of default or cross default;

• Dividend or ongoing cash payments can be deferred; and

• Subordination within the capital structure.

Trust Preferred Securities

Trust preferred securities, which include issues such as MIPS (Monthly Income Preferred Stock), QUIPS (Quarterly Income Preferred Stock) and TOPRS (Trust Originated Preferred Redeemable Stock), have the characteristics of both debt and equity instruments. These hybrid securities allow the issuer to make tax-deductible interest payments, which reduce the issuer's cost of capital while also providing equity-like benefits similar to traditional preferred stock.

Trust preferred securities generally are issued by a special-purpose trust created by its parent. The trust lends proceeds to the parent through a subordinated loan that is junior to all other debt of the parent. The terms of the preferred securities match the terms of the underlying subordinated loan.

Payment obligations of the trust typically are ensured not by a single guarantee, but through several agreements and by the terms of the debt securities that the trust holds. The agreements normally include a guarantee and an expense undertaking from the parent company; the trust indenture for the debt securities the trust holds; and the trust declaration of the trust itself.

Typical key features include:

• A long maturity, between 20 and 40 years, with an issuer call option after five years. As such, it is an obligation that must be repaid from cash flow or refinanced.

• Dividends are deferrable, subject to suspension of common dividend, for up to five years without triggering a default. Deferred amounts accumulate, accrue interest and must be paid before resuming common dividends or at the end of the limited deferral period.

• Subordination to all debt obligations of the parent and on parity with other directly issued trust preferreds. Due to the loan structure underlying the issued security, it has a more senior claim in liquidation to preferred stockholders.

• Default triggers where, as a debt claim, it is an obligation that could become due immediately in the event of a default, cross default, bankruptcy filing or other form of reorganization. Also, the existence of a call option would raise the possibility that the instrument could be replaced in the future with a new issue, with no guarantee that the refinancing will be neutral with respect to senior creditors in the issuer's capital structure.

For these reasons, A.M. Best generally views trust preferred securities as more debt-like than equity-like for all issuers.

Surplus Notes

Surplus notes typically are treated as policyholder surplus from a regulatory perspective. The issuance of surplus notes can enhance an insurer's capacity to write business while at the same time lowering policyholders' financial exposure through structural subordination.

Surplus notes that A.M. Best views as equity-like are:

• Long term, typically having a stated maturity of 10 to 30 years;

• Subordinate to policyholders, claimants, beneficiary claims and other classes of creditors; and

• Subject to regulatory approval for all interest payments and principal repayments. This feature allows regulators to restrict payments if the insurer's financial health deteriorates, without it being a default for the insurer.

Surplus notes may receive varying amounts of surplus credit in evaluating the adequacy of an insurer's capital base relative to its financial strength rating. For more information regarding risk-based capital and its influence on ratings, please refer to A.M. Best's methodologies Understanding BCAR for Life/Health and Understanding BCAR for Property/Casualty at *www.ambest.com/ratings/methodology*.

From a financial-leverage standpoint, the table, "Operating Company Financial Leverage Guidelines," illustrates A.M. Best's typical tolerance levels for the amount of surplus notes issued in the capital markets for the various rating categories (based on statutory accounting principles). For insurance subsidiaries of stock holding companies, third-party surplus notes will be included as debt when analyzing the parent company's capital structure.

Operating Company Financial Leverage Guidelines

Issuer Credit Rating	*Debt + Hybrid Securities/Capital
aaa	<15%
aa+	<20
aa/aa-	<35
a+/a/a-	<50
bbb+/bbb/bbb-	<65
bb+/bb/bb-	>65

* (Long-Term + Short-Term + Hybrid Securities†)/Surplus† (excluding Goodwill)

† Includes surplus notes.

Best's Equity-Debt Continuum

Equity	100%	75%	50%	25%	0%
Debt	0%	25%	50%	75%	100%
Maturity	No maturity or mandatory conversion to common/perpetual preferred stock	50 years or more to maturity	20 to 50 years to maturity	10 to 20 years to maturity	10 years or less to maturity at issue*
Ongoing Payments	No ongoing payments required/noncumulative	7- to 10-year cumulative dividend or interest deferral	3- to 7-year cumulative dividend or interest deferral	1- to 3-year cumulative dividend or interest deferral	Required interest/dividend payments
Subordination	Common/Perpetual Preferred Stock	Preferred Stock (w/maturity)	Trust Preferred/Junior Subordinated Debt	Subordinated Debt	Senior Debt

In general, the longer the maturity, the longer interest/dividend payments may be deferred and the deeper the subordination, the higher will be the equity credit given to a hybrid security. Those factors are blended in an overall preliminary equity-credit score before other factors are considered. That said, these instruments can be extremely complex and require extensive further rating analysis that goes well beyond that of any simple matrix. Consider the category of hybrid instruments referred to as convertible securities, which can receive equity credit ranging from 0% to 100% depending on the terms and structure of the particular instrument.

In this example, the three analytical categories are given equal weight; however, in reality, the relative importance of each can vary from one security to the next. Furthermore, the amount of equity credit provided by a hybrid security also is influenced by a host of other analytical factors (e.g., presence of a put or call option, size of issuance relative to current capital structure, and perceived permanency in capital structure).

Accordingly, the presentation of Best's Equity-Debt Continuum above is for illustrative purposes only.

* Long-dated securities at original issue date amortize to 0% credit at 3 years to maturity beginning in the tenth year to maturity.

Case Study—$500 Million Issuance of Hybrid Securities

($ Millions)

	Capital Structure	
	Prior to Issue	**Post Issue**
Debt (Senior Unsecured)	$600	$600
Hybrid Issuance		$500
Shareholders Equity	$1,800	$1,800
Capital	$2,400	$2,900
Debt + Hybrid to Equity	33.3%	61.1%
Debt + Hybrid to Capital	25.0%	37.9%

Hybrid Securities

	Issue Amount	Equity Credit	Description
Hybrid I	$500	75%	Mandatory convertible securities, five years to conversion, with a fixed conversion formula; that is, the instrument automatically converts upon maturity into common stock based on a fixed price.
Hybrid II	$500	50%	Trust preferred securities, 30 years remaining to maturity. Dividends are deferrable for up to five years without triggering a default. Deferred amounts accumulate and accrue interest.
Hybrid III	$500	25%	Optionally convertible securities with a fixed exchange rate and an issuer's call feature, exercisable after five years.

Adjusted Leverage Measures	Hybrid I	Hybrid II	Hybrid III
Debt (Senior Unsecured)	600	600	600
Debt Charge for Hybrid Issuance	125	250	375
—Debt + Hybrid Charge	$725	$850	$975
Shareholders Equity	1800	1800	1800
Equity Credit for Hybrid Issuance	375	250	125
Equity + Hybrid Credit	2175	2050	1925
—Capital	$2,900	$2,900	$2,900
Debt + Hybrid Charge to Capital	25.0%	29.3%	33.6%

GUIDE TO BEST'S RATINGS

A Best's Rating is 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 (FSR)** is an opinion of an insurer's financial strength and ability to meet ongoing obligations to policyholders.

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

A **Best's Long-Term Issuer Credit Rating (ICR)** is an opinion as to the ability of the rated entity to meet its senior obligations. In certain markets or product lines, particularly where the credit market scale is widely recognized, A.M. Best also assigns Issuer Credit Ratings to insurance companies using its Long-Term Credit Rating Scale. The definitions applied to insurance companies that are assigned a long-term Issuer Credit Rating are as follows: (aaa) - Exceptional; (aa) - Superior; (a) - Excellent; (bbb) - Very Good; (bb) - Fair; (b) - Marginal; (ccc-cc) - Weak; (c) - Poor.
A.M. Best may also assign Short-Term Issuer Credit Ratings to certain insurance companies using its Short-Term Credit Rating scale.

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 obligations).

	Rating	Descriptor
Investment Grade	aaa	Exceptional
Investment Grade	aa	Very Strong
Investment Grade	a	Strong
Investment Grade	bbb	Adequate
Non-Investment Grade	bb	Speculative
Non-Investment Grade	b	Very Speculative
Non-Investment Grade	ccc, cc, c	Extremely Speculative
Non-Investment Grade	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 prefixed with an ("i") denote indicative 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. These Issuer Credit Rating descriptors apply to entities which do not issue insurance obligations.

Rating Modifiers

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

Affiliation Codes

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

Short-Term Credit Ratings

A.M. Best uses its short-term credit rating scale when assigning:
- **Debt Ratings** (an opinion as to the issuer's ability to meet its obligations having maturities generally less than one year) and
- **Issuer Credit Ratings** (an opinion as to the ability of the rated entity to meet its senior financial commitments on obligations maturing in generally less than one year).

	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

A company's Short-Term Credit Rating also may be assigned an Under Review modifier ("u") that generally is event-driven (positive, negative or developing) and indicates that the company's Best's Rating opinion is under review and may be subject to near-term change. Ratings prefixed with an ("i") denote indicative ratings.

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

Rating Outlook

Best's Ratings (A++ to D, aaa to c) 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. Public Data Ratings are not assigned an Outlook. 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.

Best's Ratings are distributed via press release and/or the A.M. Best Web site at *www.ambest.com*, and are published in the *Rating Monitor* section of *BestWeek*®. **Version 121304**

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