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### Additional Information

#### Criteria:

A.M. Best's Ratings & the Treatment of Debt

Understanding BCAR for  
Property/Casualty Insurers

Understanding BCAR for Life & Health Insurers

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This criteria report was updated as part of the annual review process. No substantive changes were made to the prior edition.

This criteria report can be found at  
[www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology)

## Equity Credit For Hybrid Securities

The increased use of nontraditional debt securities within the insurance industry 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 than through the equity markets.

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](http://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 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

### Equity Characteristics

- Permanency of capital;
- Ability to defer interest or dividend payments; and
- Subordination in an issuer's capital structure (loss protection provided to senior creditors).



reported balance sheet financial leverage by giving, or possibly removing, equity credit for 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 through interest-deferral features, 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-adjusted 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 Insurers* at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology).

### Rating Methodology

When assessing a specific entity's capital structure, A.M. Best reviews 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 composition of its capital base going forward. This understanding is of particular importance when attempting to quantify equity credit for hybrid secu-

rities, 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 or 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 it may in fact issue new debt securities to fund a share repurchase.

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, A.M. Best calculates coverage ratios including hybrid obligations.

As a general guideline, holding companies with financial leverage ratios less than 35% (adjusted for equity credit) on a consolidated basis are considered to have an acceptable level of debt and hybrids for "a-" or higher issuer credit ratings (ICRs); the range of 35% to less than 45% is considered acceptable for issuer credit ratings in the "bbb" category; and leverage ratios greater than 45% are associated with ICRs of "bb" and below (see **Exhibit 2**).

### Best's Equity-Debt Continuum

The equity-debt continuum shown in **Exhibit 1** 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 (loss absorption), maturity (permanency of capital) and the

cash-flow flexibility (deferability) provided by its terms and features.

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 common stock 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 in **Appendix 1** reflects A.M. Best's typical perspective, though rating committees have flexibility to adjust equity credit attribution based on individual circumstances.

#### Exhibit 1

#### 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, with no put options that present refinancing or repayment risk;
- Ability to defer ongoing payments; 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.

#### Exhibit 2

#### 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 equity credit)/[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.

#### **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 close to 100% equity credit within two years of conversion. Securities with a floating exchange rate are 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 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 non-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.

- Such securities are subordinated 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 the parent company. 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.

### Surplus Notes

In the United States, surplus notes typically are treated as policyholders' 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.

From a financial leverage standpoint, **Exhibit 3** illustrates A.M. Best's typical tolerance levels for the amount of surplus notes, or other debt-like securities, issued by operating companies to unaffiliated investors for the various rating categories. For insurance subsidiaries of stock holding companies, third-party surplus notes will be included as debt when analyzing the parent company's capital structure.

Surplus notes may receive varying amounts of capital credit in evaluating the adequacy of an insurer's risk-adjusted capital. For more information regarding risk-adjusted 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 Insurers* at [www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology).

### Exhibit 3 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†)/Equity† (excluding Goodwill)

† Includes surplus notes.

# Appendices

## Appendix 1

### Best's Equity – Debt Continuum

<b>Equity</b>	<b>100%</b>	<b>75%</b>	<b>50%</b>	<b>25%</b>	<b>0%</b>
<b>Debt</b>	<b>0%</b>	<b>25%</b>	<b>50%</b>	<b>75%</b>	<b>100%</b>
<b>Maturity*</b>	No maturity	50 years or more to maturity	20-50 years to maturity	10-20 years to maturity	10 years or less to maturity at issue
<b>Ongoing Payments</b>	No ongoing payments required	7-10 year cumulative dividend or interest deferral	3-7 year cumulative dividend or interest deferral	1-3 year cumulative dividend or interest deferral	Required interest/dividend payments
<b>Subordination</b>	Common Stock	Preferred Stock	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 varying degrees of equity credit, depending on the terms and structure of the particular instrument.

In the example above, 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 three years to maturity beginning in the 10th year to maturity.

## Appendix 2

### Case Study – \$500 Million Issuance of Hybrid Securities

(\$ Millions)

**Capital Structure**

	Prior 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 Amt	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, a call option after five years. 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**

	I	II	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%

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## Methodology

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