

A.M. Best's Perspective on Operating Leverage

Introduction

In forming an overall opinion of a company's balance sheet strength — the most important area in determining a company's ability to meet its current and ongoing obligations to policyholders — A.M. Best Co. reviews the organization's financial leverage. Financial leverage, through debt or debt-like instruments, may place a call on an insurer's earnings and strain its cash flow. Also, excessive financial leverage at the operating or holding company can lead to financial instability. Please refer to *Equity Credit For Hybrids at www.ambest.com/ratings/methodology/hybridsecurities.pdf* for A.M. Best's financial leverage guidelines.

Generally, the debt portion of an insurer's capital structure is utilized as working capital for its insurance lines. For organizations with debt-issuing holding companies atop, dividends from the insurance subsidiaries typically represent a major source of debt service. Diversified enterprises that possess significant non-insurance operations, such as consumer finance and mortgage banking, may require additional funding. If the financing of other operations is to be serviced solely by the non-insurance businesses and meets the eligibility requirements outlined below, A.M. Best would likely consider the debt as operating leverage rather than financial leverage. These businesses are usually not guaranteed by the lead insurance company, and the debt typically is match-funded with corresponding assets such as credit card receivables or mortgages. However, A.M. Best will consider extraordinary notching of debt securities issued by holding companies with highly leveraged non-insurance operations, as well as the potential impact on the

insurance company's financial strength.

For organizations that issue debt or debt-like instruments directly from an operating insurance company, amounts eligible for operating leverage treatment generally would involve cases where residual risk to the insurer is insignificant. Because financial instruments may be issued either by holding companies or by operating companies (or by both), A.M. Best will apply specific tolerances at each operating company as well as on a consolidated basis. If the tolerance is exceeded at an individual operating company or in aggregate, A.M. Best would monitor closely the issuer's penchant for retail notes and/or institutional spread-based (ISB) products and would contemplate lowering the entity's stand-alone rating if growth trends vary substantially from previous expectations. (Please see Step 1 on page 3 for operating company examples.) Ultimately, debt obligations viewed by A.M. Best as operating leverage would be excluded fully from the calculation of consolidated financial leverage, unless the tolerance level is exceeded. (Please refer to Step 2, for consolidated view.)

Examples and Eligibility

A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets should be sufficient to fund the interest and principal payments associated with the obligations. Additionally, the insurer must possess sound asset/liability and investment risk management capabilities, adhere to low duration mismatch tolerances, and maintain negligible repayment and liquidity risk related to these obligations. Some examples of activities that typically would be viewed as operating leverage include:

- Securities lending programs
- Repurchase and reverse repurchase agreements (repos)
- Federal Home Loan Bank (FHLB) borrowings

Questions regarding A.M. Best's Operating Leverage methodology can be directed to Andrew Edelsberg, assistant vice president, or Darian Hala, financial analyst, both in the Life/Health division of A.M. Best Co.



- Guaranteed investment contracts (GICs) and funding agreements
- Funding Agreement-Backed Securities Programs (FABS)
- Retail note programs
- Commercial paper used for spread-lending activities
- Commercial paper supporting credit card receivables (consumer finance operations)
- Premium financing operations
- Debt related to Regulation XXX or AXXX securitizations.

With respect to closed block monetizations, A.M. Best would tend not to view the debt associated with these transactions as operating leverage. A.M. Best recognizes the stable, long-term nature of the closed block liabilities and the steady earnings generated by the assets supporting the business. The impact on an organization's business profile of eliminating the closed block's future earnings and deploying the debt proceeds in higher-risk, higher-return businesses will be incorporated in the overall financial strength evaluation. However, A.M. Best's tolerance for financial leverage for that company likely would increase depending on the characteristics of the inforce block.

Securities lending programs are viewed by A.M. Best as a low-risk activity because of the generally high quality of the underlying assets. These programs usually are governed by formal investment guidelines that have established limits for interest rate, reinvestment and counterparty risks. Also, asset/liability durations are managed tightly — consistent with the short-term nature of these programs.

FHLB programs provide financial flexibility for insurance company members and are an attractive source of capital because of the low rates offered on advances. For companies that invest the loan proceeds in their core businesses, these obligations would be viewed as financial leverage. However, more recently, insurers have utilized these borrowings to enhance investment yields. Success in this yield-enhancement strategy requires strong asset/liability and liquidity management expertise. This variant of an institutional spread-based product is viewed as operating leverage by A.M. Best because of characteristics similar to other ISB products such as GICs (general account, separate account and synthetic), funding agreements, FABS and retail notes.

Another type of debt obligation that A.M. Best would consider for operating leverage treatment is one that is a byproduct of a securitization (e.g., debt issued to fund XXX/AXXX reserve redundancies). In these structures, the assets are segregated and placed in a Reg. 114 trust for the benefit of the policyholders. The cash flows generated are projected to be more than sufficient to fund the debt payments, i.e., the securitization structure typically contains some overcollateralization. Also, these structures regularly involve the issuance of debt that is nonrecourse to the direct writer through a special-purpose vehicle.

Accordingly, financings resulting from the aforementioned activities typically would be viewed by A.M. Best as operating leverage if the insurer possesses strong asset/liability, liquidity and investment management skills; and duration mismatch is kept at a minimum. In addition, nonrecourse debt would be viewed more favor-

A.M. Best Co.

Methodology

November 2006

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The Insurance Information Source

ably when calculating a company's financial leverage. For financings to receive operating leverage treatment in the financial leverage ratio calculation, A.M. Best must be able to (1) analyze the assets supporting these debt issuances, and (2) understand management controls and the

structure of the funding mechanism. Moreover, A.M. Best will consider the potential volatility of the assets supporting the debt fundings, as well as prospective operating leverage at all subsidiaries, including international.

Operating Leverage Definitions and Examples

STEP 1

Example 1 - ABC Insurance Company:

Product	Amt. O/S (\$ mil)
GICs	-
FABS	-
FAs	3,600
Retail Notes	-
Securities Lending	1,000*
FHLB Borrowings	800
Total OCB	5,400
General Account Reserves (Annual Statement lines 1-6.3)	9,000
OCB/GA Reserves	60%

This exceeds A.M. Best's 50% tolerance for a statutory entity. Hence, A.M. Best would closely monitor the company's appetite for these products and contemplate lowering the issuer's stand-alone rating if growth trends vary from A.M. Best's expectations.

Example 2 - XYZ Insurance Company:

Product	Amt. O/S (\$ mil)
GICs	400
FABS	1,400
FAs	200
Retail Notes	-
Securities Lending	950
FHLB Borrowings	650
Total OCB	3,600
General Account Reserves (Annual Statement lines 1-6.3)	10,000
OCB/GA Reserves	36%

This does not exceed A.M. Best's 50% tolerance for statutory entities.

Operating Company Borrowings (OCB) = GICs, FABS, funding agreements (FAs), retail notes, securities lending and FHLB advances

Total Balance Sheet Leverage = Consolidated balance sheet debt-to-capital ratio (unadjusted)

Financial Leverage = Debt-to-capital ratio assuming full operating leverage credit

Total Operating Borrowings = Operating company + Holding company operating borrowings (i.e. Operating Corporate Debt)

Composition Ratio = Total Operating Borrowings / Consolidated GAAP liabilities less separate account liabilities

Adjusted Financial Leverage Ratio = Ratio that reflects the Financial Leverage + any operating leverage amounts exceeding the holding company tolerance

STEP 2

Example 1 - ABC Holding Company, Inc.:

Balance Sheet Item	Amt. (\$ mil)
Short-Term Debt	600
Long-Term Debt	1,500
Oper. Corp. Debt	1,000*
Total Debt	3,100
Total Equity	7,900
Total Capital	11,000
Total GAAP Liabilities	25,000
Total OCB	5,400
Total Operating Borrowings	6,400 (5,400 + 1,000)
Total Balance Sheet Leverage	28% (3100/11000)
Financial Leverage	21% (3100-1000)/ (11000-1000)
Composition Ratio	26% (< 35%)
Tolerance	8,750 (.35)(25000)
Amount Exceeding Tolerance	- (6400-8750)
Adjusted Financial Leverage	21% (3100-1000)/ (11000-1000)

For analytical purposes, this group's financial leverage ratio will reflect full credit for \$1 billion in operating leverage (*)

Example 2 - XYZ Holding Company, Inc.:

Balance Sheet Item	Amt. (\$ mil)
Short-Term Debt	600
Long-Term Debt	1,500
Oper. Corp. Debt	2,300**
Total Debt	4,400
Total Equity	5,600
Total Capital	10,000
Total GAAP Liabilities	15,000
Total OCB	3,600
Total Operating Borrowings	5,900 (3,600 + 2,300)
Total Balance Sheet Leverage	44% (4400/10000)
Financial Leverage	27% (4400-2300)/ (10000-2300)
Composition Ratio	39% (> 35%)
Tolerance	5,250 (.35)(15000)
Amount Exceeding Tolerance	650 (5900-5250)
Adjusted Financial Leverage	33% (4400-2300+650)/ (10000-2300+650)

For analytical purposes, this group's financial leverage ratio will reflect partial credit (\$1.65 B) for its \$2.3 B in operating leverage (**)

Operating Leverage Limits

A.M. Best views operating leverage-related activities as reasonable activities for highly rated companies with diverse business lines, considerable expertise in asset/liability and investment management, and sufficient financial flexibility. However, the greater an insurer's exposure to these liabilities, the greater the stress on its liquidity profile, particularly in certain situations such as a rating downgrade or a contract containing negative covenants. Hence, A.M. Best is most comfortable when operating leverage activities such as institutional investment products and spread-lending do not constitute a large proportion of general account liabilities.

A.M. Best has developed specific guidelines for each operating company of a group and all operating companies combined (statutory view; see Step 1). In short, A.M. Best would be uncomfortable with a statutory entity or group if the sum of ISB product liabilities, retail notes outstanding, liability for securities lending and FHLB loans exceeds 50% of general-account "reserves" (defined here as lines 1 through 6.3 of the Life/Health Annual Statement). As mentioned

previously, A.M. Best would monitor closely the issuer's appetite for these products and contemplate lowering the entity's stand-alone rating if growth trends vary substantially from previous expectations.

A.M. Best also will perform a test at the consolidated holding company level (GAAP; see Step 2) to determine the full impact of operating leverage treatment on an organization's published debt-to-capital ratio. Credit for operating leverage will be reduced if the sum of ISB product liabilities, retail notes outstanding, liability for securities lending, FHLB loans and match-funded holding company debt exceeds 35% of consolidated (GAAP) liabilities, excluding separate account liabilities.

Finally, for analytical purposes, A.M. Best will consider the impact of this exercise on the organization's interest coverage ratios. If debt is determined to be operating leverage, then the interest expense associated with those securities is excluded from the interest coverage calculation. Similarly, the income related to operating leverage activities would be excluded from the numerator (e.g. income from ISB products).



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