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Rating Surplus Note and Insurance Trust-Preferred CDOs

The first securitization of surplus notes (SNs) and insurance trust preferreds (ITPs) occurred in 2002. This insurance collateralized debt obligation (known as SN/ITP CDO) has opened up a new funding source for small to medium-sized insurance companies that find it cost prohibitive to issue capital on their own or whose Financial Strength Ratings (FSRs) are not favorable enough for such independent capital-raising efforts. Surplus notes are attractive to issuers for two primary reasons: Interest is tax deductible, and they generally increase surplus. Insurance trust preferreds are attractive to issuers because dividends paid are tax deductible and they receive some level of equity credit. This methodology outlines A.M. Best's rating process for rating such insurance-related CDOs.

General Transaction Structure and Features

The notes in SN/ITP CDOs typically are co-issued by two stand-alone, special-purpose vehicles (SPVs) – one incorporated in the United States and the other incorporated in a tax-friendly jurisdiction such as the Cayman Islands. The SPVs have no prior operating experience and are limited to acquiring the portfolio of assets, issuing the notes and engaging in certain related activities.

The notes issued by the typical SN/ITP CDO generally consist of rated, 30-year senior and mezzanine notes and an unrated equity tranche. Proceeds from the rated and unrated securities generally are used to purchase the transaction's collateral, which consists of surplus notes, insurance trust preferreds and a small number of senior notes. In the transactions rated by A.M. Best, the collateral not only includes newly issued surplus notes and insurance trust preferreds maturing in 30 years, but also long-dated senior notes and insurance obligations purchased in the secondary markets. For simplicity, we will only refer to the collateral as consisting of newly issued surplus notes and insurance trust preferreds, unless otherwise stated.

Interest and principal payments to noteholders in a SN/ITP CDO are derived primarily from the collateral's interest and principal proceeds. To avoid an event of default, the senior notes generally must receive interest and principal when due. Interest on the mezzanine notes, however, may be capitalized if there are insufficient funds to pay the amount due. The equity investors generally are entitled to receive all excess funds. In some structures, the equity investors have a cap on their returns for a specified period.

The collateral in a SN/ITP CDO generally consists of about 35 or more newly issued surplus notes and insurance trust preferreds that are non-amortizing and due in 30 years. Other types of insurance-related collateral, such as surplus notes and insurance trust preferreds purchased in the secondary markets, generally have maturities less than 30 years, but they are relatively small compared with the newly issued surplus note and insurance trust-preferred balances.

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



Description of Trust-Preferred Securities and Surplus Notes

The insurance companies that issue the surplus notes and insurance trust preferreds generally are small to medium-sized insurers domiciled in the United States with a minimum A.M. Best Issuer Credit Rating of “bbb-”. The size of the collateral pools normally ranges from \$300 million to \$500 million. A majority of the collateral consists of primary issuances, with the remainder derived from the secondary market. To date, nearly all the collateral pools for the SN/ITP CDOs rated by A.M. Best have been static pools, thereby lessening the importance of the collateral manager. Below are details of the basic features of surplus notes and insurance trust preferreds, which are illustrated in **Exhibit 1**.

Surplus Notes

Surplus notes are issued directly by a mutual insurance company. As unsecured

obligations, they are subordinate in right of payment to all senior indebtedness and policy claims of the issuer. Typically, no restrictions limit the issuer from incurring additional senior indebtedness. In addition, each payment of interest and principal under a surplus note is subject to the approval of the appropriate state regulator. Any failure by the issuer to make a payment of principal or interest due to a disapproval of such payment by a state regulator generally does not constitute an event of default under the surplus note’s legal documents.

Insurance Trust Preferreds

The insurance trust preferred issuer normally is organized as a statutory business trust whose insurance holding company owns all of its beneficial interest. The insurance holding company issues a junior subordinated debenture to the trust that, in turn, issues an insurance trust preferred (i.e. long-term subordinated debt) to the SPVs used in

A.M. Best Company

Methodology

August 5, 2009

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relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer’s current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any other risk, including, but not limited to, an insurer’s claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

A Best’s Debt/Issuer Credit Rating is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. It is based on a comprehensive quantitative and qualitative evaluation of a company’s balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

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In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

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the SN/ITP CDO. The terms and conditions under the junior subordinated debenture mirror those under the insurance trust preferred; thus, the trust acts as a “pass-through” structure for the interest and principal payments. The insurance holding company guarantees that payments made to the statutory trust under the subordinated debenture will be paid to the SPV, but it does not guarantee payments will be made to the statutory business trust.

The payments received from the parent holding company under the junior subordinated debenture are the only source of funds for payments on the insurance trust-preferred security. The junior subordinated debenture is a subordinated debt instrument of the parent holding company. No restrictions limit the holding company from incurring additional senior indebtedness. The holding company is allowed to defer interest payments under the terms of the junior subordinated debenture for a total period of five years. The deferral of interest payments to the junior subordinated debenture will result in the deferral of interest payments to the insurance trust preferred, thus decreasing the amount of cash available to the SPV to make payments on the notes.

Insurer Credit Risk

A.M. Best believes that general corporate-bond default statistics are inappropriate for assessing insurer credit risks because of the unique regulatory and accounting environment in which insurers operate, and because relatively few insurers issue public debt. As such, there are very few data points available to perform a meaningful insurance default study based on the generally accepted definition of default: missed interest or principal payments on financial obligations or a bankruptcy filing. Therefore, “financial impairment” is a more measurable indication of financial duress for insurance companies.

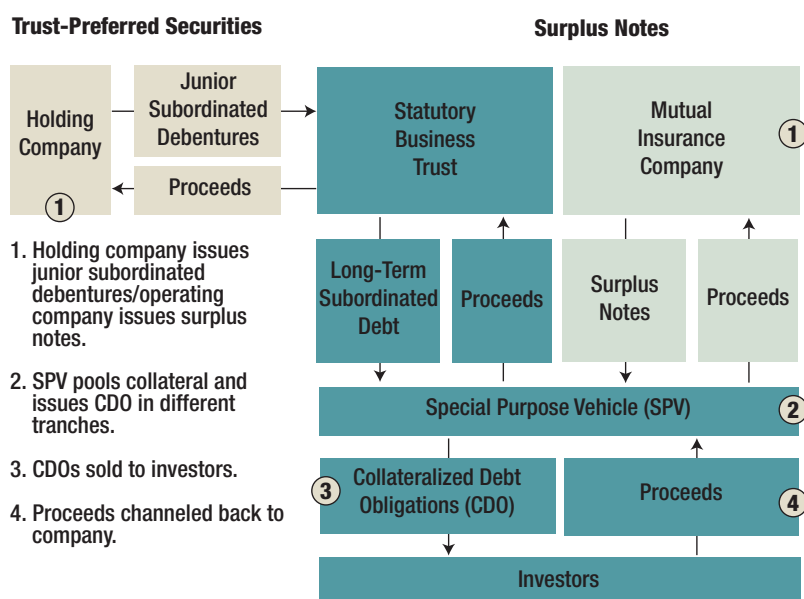
A.M. Best designates a company as financially impaired upon the first official regulatory action taken by a state insurance department. Such actions include involuntary liquidations because of insolvency, as well as other regulatory processes such as supervision, rehabilitation, receivership, conservatorship, a cease-and-desist order, suspension, license revocation, administra-

tive order or any other action that restricts an insurance company’s freedom to conduct its insurance business as normal. Companies that enter voluntary liquidation and are not under financial duress at that time are not counted as financially impaired.

It is important to note that financial impairment of insurance companies often occurs even if the companies have not been declared insolvent. For instance, an impaired company’s capital and surplus could have been deemed inadequate to meet risk-based capital requirements, or there might have been regulatory concern regarding its general financial condition. Thus, at any given rating level, more insurers would be impaired, according to the A.M. Best definition, than actually would default on policyholder obligations or, perhaps, on other obligations, such as senior or subordinated debt.

Based on the definition of financial impairment, A.M. Best has conducted and continues to conduct extensive studies to determine the impairment rates of insurance operating companies. These impairment rates can serve as proxies for defaults on financial obligations made by those companies. The latest study at the time of this writing, *Best’s Impairment Rate and Rating Transition Study – 1977 to 2008*, published

Exhibit 1 Surplus Notes/Trust-Preferred Pool



Source: A.M. Best Co.

in May 2009, covers more than 5,000 operating insurance companies that carried a Best's FSR from Dec. 31, 1977, to Dec. 31, 2008. In that period, on average 22.4 companies per year – or 694 operating insurance companies – were designated as financially impaired. **Exhibit 2**, Best's Cumulative Average Impairment Rates, shows the one-year to 15-year cumulative average impairment rates in the most recent impairment study at the time of this writing. Updates to this study are posted on A.M. Best Co.'s Web site (www.ambest.com).

The reader should be aware that A.M. Best has an equivalent issuer credit rating (ICR) on the credit market scale, familiar to capital market participants, for nearly all FSRs it issues. The translation from FSRs to ICRs is shown in **Exhibit 3**. As an example, an operating insurance company with an FSR of "A+" would have an ICR of either "aa" or "aa-", depending on the results of the analysis done by the rating analyst for the company in question. For more information on the translation of FSRs to ICRs, please see *A.M. Best's Ratings and the Treatment of Debt*, published Oct. 11, 2004.

In the context of credit risk of insurers or insurance holding companies issuing debt instruments, ICRs are significant because A.M. Best's idealized default rates for insurers (which are, in part, derived from A.M. Best's impairment studies) are shown on the credit market scale familiar

to capital market participants. **Exhibit 4** shows the idealized default rates assumed for insurance operating companies on the traditional credit market scale. The default rates on this table are applied to the insurance companies in SN/ITP CDOs.

A.M. Best has FSRs and/or ICRs on nearly all of the insurance holding companies and mutual insurance companies that have issued surplus notes and insurance trust preferreds in SN/ITP CDO transactions in the transactions it has rated so far. A report on all rated insurance companies can be found in *Best's Insurance Reports*. A.M. Best's methodologies on the quantitative evaluation of insurance companies are found, respectively, in *Understanding BCAR for Property/Casualty Insurers* and *Understanding BCAR for Life & Health Insurers* (See www.ambest.com/ratings/methodology).

Protection for the Noteholders

A.M. Best considers the structural protections inherent in notes of SN/ITP CDOs in the rating process. These features include: coverage tests; amortization of notes in the event of defaults/deferrals; a required auction of the collateral beginning in the 10th year; a mandatory diversion of a portion of the cash flow from equity holders to senior and mezzanine noteholders after each failed auction; and the option by equity holders to purchase the entire pool of collateral and/or the defaulted/interest-deferred collateral.

Exhibit 2

Best's Cumulative Average Impairment Rates

U.S. life/health and property/casualty data from 1977 to 2008.

	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>	<u>12</u>	<u>13</u>	<u>14</u>	<u>15</u>
A++/A+	0.06%	0.19%	0.34%	0.51%	0.66%	0.89%	1.12%	1.38%	1.68%	2.00%	2.33%	2.76%	3.22%	3.68%	4.02%
A/A-	0.19%	0.56%	1.04%	1.54%	2.09%	2.68%	3.27%	3.91%	4.49%	5.05%	5.62%	6.13%	6.60%	6.98%	7.35%
B++/B+	0.75%	1.75%	2.79%	4.07%	5.43%	6.62%	7.82%	8.78%	9.55%	10.38%	11.21%	12.08%	12.95%	13.84%	14.46%
B/B-	2.06%	4.23%	6.28%	8.08%	9.93%	11.89%	13.77%	15.41%	17.02%	18.56%	20.13%	21.67%	23.09%	24.37%	25.57%
C++/C+	3.41%	5.73%	8.58%	11.40%	13.70%	16.02%	18.13%	21.01%	23.57%	25.28%	26.66%	27.60%	28.60%	29.68%	30.45%
C/C-	6.02%	9.63%	12.36%	15.12%	18.16%	22.14%	25.54%	28.96%	31.57%	33.85%	36.60%	38.86%	40.82%	42.91%	45.18%
D	7.27%	12.19%	16.99%	21.24%	25.41%	29.50%	32.87%	35.80%	38.31%	40.72%	43.11%	45.05%	46.72%	48.20%	49.48%
Secure	0.25%	0.65%	1.11%	1.62%	2.17%	2.71%	3.27%	3.81%	4.30%	4.81%	5.32%	5.85%	6.38%	6.87%	7.27%
Vulnerable	3.62%	6.47%	9.25%	11.80%	14.32%	16.97%	19.36%	21.66%	23.74%	25.59%	27.43%	29.04%	30.50%	31.88%	33.12%
All	0.69%	1.41%	2.17%	2.94%	3.73%	4.55%	5.33%	6.10%	6.81%	7.50%	8.19%	8.87%	9.54%	10.16%	10.68%

Source: *Best's Impairment Rate and Rating Transition Study – 1977 to 2008*, published May 1, 2009.

Coverage Tests

Principal and interest coverage tests often are employed as mechanisms for delevering (i.e. reducing the rated note balances) the transaction. The triggers usually are set such that in the event of excessive impairments of the collateral, the payments to senior noteholders are accelerated. The coverage tests, as described in the indenture, are included in A.M. Best's model of the transaction.

Amortization of Notes Due to Defaults/Deferrals

In some structures, if defaults occur in the collateral pool, the cash flow that ordinarily goes to the equity holders is diverted to amortize the most senior notes outstanding, thus delevering the transaction. Such amortizations generally continue on each payment date until the total amount of the diverted cash flow is equal to the principal balance of the defaulted collateral. Other structures depend entirely on their coverage tests and the remedies prescribed in the event of failures of such tests to divert cash flow to the senior noteholders.

Exhibit 3 Translation of Financial Strength Rating to Issuer Credit Rating

FSR (Operating Insurance Co.)	Equivalent ICR on Credit Market Scale (Operating Insurance Co.)
A++	aaa
	aa+
A+	aa
	aa-
A	a+
	a
A-	a-
B++	bbb+
	bbb
B+	bbb-
B	bb+
	bb
B-	bb-
C++	b+
	b
C+	b-

Source: A.M. Best's *Ratings & the Treatment of Debt*, published Oct. 11, 2004.

The interest on the insurance trust preferreds can be deferred for up to five years. Typically, SN/ITP CDOs consider collateral on which interest is deferred as securities in default, even though such deferrals are permissible and not considered an event of default in the indenture of the deferrable interest debentures. For some structures, in the event of interest deferrals, the cash flow that ordinarily goes to the equity holders is diverted to amortize the most senior notes outstanding until the diverted cash flow is equal to the principal balance of the interest-deferred collateral.

Auction Call Redemption

Commencing on the 10th anniversary, the trustees in the transactions generally are required to periodically solicit bids in an auction of the collateral. The trustee must accept the highest bid if that bid is at least generally equal to the sum of the principal balance of the senior notes, the mezzanine notes, the accrued and unpaid interest on the notes, and other specified expenses. The proceeds from the auction would be used to fully retire the notes, with any excess funds accruing to equity investors. For its analysis, A.M. Best assumes the notes will be outstanding for the entire 30-year period.

Equity Investor Refinancing

Under some structures, with the concurrence of a majority of equity investors, after the fifth year through year 10, the equity investors can purchase all of the collateral from the SPVs as long as the proceeds from the sale repay the existing noteholders. The trustee will accept the highest bid submitted as long as the bid repays the existing noteholders. In addition, after year 10, a significant percentage (generally 60% or more) of cash flow will be diverted from the equity investors to prepay the noteholders. These structural features make it unlikely that the CDO facility will remain in place until its scheduled maturity of 30 years. Nonetheless, A.M. Best evaluates a structure with this feature as if it were to remain until the stated maturity date, given that the trustee may not find a buyer for the collateral pool.

Interest Rate Hedges

Interest rate risk is present in all structures, given the fixed/floating nature of the

collateral and notes. Interest rate hedges and/or interest rate caps normally are used to mitigate this interest-rate mismatch; however, there always is the risk that an unhedged mismatch still may occur. A.M. Best, through sensitivity analysis, evaluates the potential unhedged mismatch and its impact on the structure’s cash flows. A.M. Best expects a minimum issuer credit rating of “a” for any swap or hedge counterparty provider. If A.M. Best does not rate the swap or hedge counterparty provider, a long-term unsecured debt rating equivalent is required from another Nationally Recognized Statistical Rating Organization.

Other Features

In some structures, once the equity investors receive a predetermined yield, any excess cash is used to repay the noteholders. Other structures have a feature that prevents cash from being distributed to the equity investors if a collateral security is in default. Distributions to the equity investors will not resume until the principal amount of the defaulted security has been paid to the noteholders via the diverted cash. This cash-diversion feature is considered fully in A.M. Best’s model of the transaction.

Modeling and Stress Testing

A.M. Best applies the Monte Carlo simulation process to analyze the cash flows of SN/ITP CDOs. To determine the cash flow of each surplus note and insurance trust-preferred security, A.M. Best requires specific information with regard to the collateral pool, such as issuer name, ICR of the issuing entity, type of security, principal amount, yield, tenor and other information necessary for modeling the transaction. A copy of the most recent draft indenture or offering circular are required to model the features of the SN/ITP CDO.

Applying Assumed Default Rates

For an insurer rated by A.M. Best, the assumed default rate associated with its ICR is used as a proxy for its default probability. A.M. Best assumes that the default probability of all obligations – insurance policy, contract obligations and debt obligations – of a given insurance company are the same. Therefore, the only distinguishing characteristics of the obligations are the applicable recovery rates, which are covered later in this section.

If an issuer is not rated by A.M. Best but is rated by another rating agency, the long-term unsecured debt rating of that

**Exhibit 4
Best’s Idealized Default Rates of Insurers**

On the credit market scale.

Years	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-
1	0.03%	0.06%	0.11%	0.16%	0.21%	0.23%	0.27%	0.67%	1.20%	2.30%	5.80%	7.61%	9.41%	10.17%	11.32%	11.98%
2	0.11%	0.32%	0.44%	0.56%	0.67%	0.74%	0.89%	1.96%	3.26%	5.28%	10.60%	14.35%	18.22%	19.40%	21.50%	22.75%
3	0.20%	0.58%	0.76%	0.95%	1.13%	1.25%	1.51%	3.18%	5.23%	8.10%	15.08%	20.60%	26.23%	27.74%	30.61%	32.40%
4	0.31%	0.84%	1.08%	1.33%	1.58%	1.76%	2.13%	4.35%	7.11%	10.78%	19.26%	26.37%	33.48%	35.27%	38.75%	41.01%
5	0.45%	1.10%	1.41%	1.71%	2.02%	2.25%	2.75%	5.46%	8.91%	13.31%	23.14%	31.69%	40.05%	42.04%	45.99%	48.67%
6	0.60%	1.37%	1.73%	2.09%	2.46%	2.74%	3.37%	6.51%	10.63%	15.71%	26.75%	36.58%	45.96%	48.11%	52.40%	55.45%
7	0.77%	1.64%	2.06%	2.47%	2.88%	3.21%	3.98%	7.51%	12.26%	17.96%	30.09%	41.06%	51.27%	53.53%	58.04%	61.43%
8	0.96%	1.92%	2.38%	2.84%	3.31%	3.68%	4.58%	8.45%	13.81%	20.09%	33.18%	45.14%	56.02%	58.35%	62.99%	66.67%
9	1.15%	2.20%	2.70%	3.21%	3.72%	4.13%	5.18%	9.34%	15.28%	22.08%	36.04%	48.86%	60.25%	62.62%	67.31%	71.24%
10	1.36%	2.48%	3.03%	3.58%	4.13%	4.58%	5.76%	10.18%	16.67%	23.95%	38.66%	52.23%	64.01%	66.40%	71.06%	75.21%
11	1.58%	2.76%	3.35%	3.94%	4.53%	5.01%	6.33%	10.96%	17.98%	25.70%	41.07%	55.27%	67.32%	69.71%	74.29%	78.63%
12	1.81%	3.05%	3.68%	4.30%	4.92%	5.43%	6.88%	11.69%	19.21%	27.34%	43.28%	58.01%	70.22%	72.60%	77.06%	81.56%
13	2.05%	3.35%	4.00%	4.65%	5.31%	5.84%	7.42%	12.36%	20.36%	28.86%	45.30%	60.46%	72.75%	75.12%	79.42%	84.05%
14	2.29%	3.64%	4.32%	5.01%	5.69%	6.25%	7.93%	12.99%	21.44%	30.28%	47.14%	62.64%	74.94%	77.30%	81.41%	86.16%
15	2.53%	3.94%	4.65%	5.36%	6.06%	6.64%	8.43%	13.57%	22.43%	31.59%	48.82%	64.59%	76.81%	79.17%	83.09%	87.94%

Source: Derived from Best’s Idealized Default Matrix, published Dec. 5, 2007.

rating agency and the applicable default probability, if known and available, will be applied to the surplus note, insurance trust-preferred security, senior notes or other unsecured debt. Entities with no ratings from any rating agencies, and that have not become impaired in the past, generally will be assigned a rating of “bb+”, the highest non-investment grade ICR issued by A.M. Best. Insurance companies and other entities with no ratings from any rating agencies and that have become impaired in the past (and recovered from such impairment) will be assigned an ICR of “b.” It should be noted that entities with no ratings from any rating agencies will be downgraded severely in the stress scenarios presented to A.M. Best’s credit rating committee.

Correlation

A.M. Best assumes impairments on small to midsize insurance companies are largely uncorrelated. However, in times of economic stress such as was experienced in 2008 and 2009, A.M. Best will increase default probabilities in stress scenarios to reflect the effect of any default correlations that may be inherent in the collateral pool of SN/ITP CDOs.

Recoveries

There are very few historical data available on the recoveries on surplus notes and insurance trust preferreds because of the relatively few insurance companies that have issued such securities. In addition, because the securities generally are not publicly traded, recovery values after impairments cannot be observed easily. In the current SN/ITP CDOs rated by A.M. Best, the recovery percentages have been quite low (if there are any at all), and no consistent recovery pattern is evident. For this reason, A.M. Best will apply zero recoveries to the defaults associated with surplus notes, trust-preferred securities or any other junior debt in the SN/ITP collateral pool.

Monte Carlo Simulation

After assigning default probabilities to surplus notes, insurance trust preferreds and other securities in the transaction, each asset in the collateral pool is modeled individually using the Monte Carlo simulation technique to determine whether the issuing entities are in default. A.M. Best tests the debt and interest-repaying capability of the collateral pool over a large number of scenarios. Any missed mandatory pay-

Exhibit 5

Best’s Idealized Default Matrix

On the credit market scale.

Years	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-	ccc+	ccc	ccc-
1	0.03%	0.03%	0.04%	0.05%	0.06%	0.11%	0.16%	0.21%	0.23%	0.27%	0.67%	1.20%	2.30%	2.81%	5.80%	7.61%	8.51%	9.41%	10.17%
2	0.08%	0.11%	0.13%	0.23%	0.32%	0.44%	0.56%	0.67%	0.74%	0.89%	1.96%	3.26%	5.28%	7.30%	10.60%	14.35%	16.84%	18.22%	19.40%
3	0.14%	0.20%	0.26%	0.42%	0.58%	0.76%	0.95%	1.13%	1.25%	1.51%	3.18%	5.23%	8.10%	11.46%	15.08%	20.60%	24.46%	26.23%	27.74%
4	0.22%	0.31%	0.41%	0.62%	0.84%	1.08%	1.33%	1.58%	1.76%	2.13%	4.35%	7.11%	10.78%	15.33%	19.26%	26.37%	31.41%	33.48%	35.27%
5	0.31%	0.45%	0.58%	0.84%	1.10%	1.41%	1.71%	2.02%	2.25%	2.75%	5.46%	8.91%	13.31%	18.90%	23.14%	31.69%	37.74%	40.05%	42.04%
6	0.42%	0.60%	0.79%	1.08%	1.37%	1.73%	2.09%	2.46%	2.74%	3.37%	6.51%	10.63%	15.71%	22.19%	26.75%	36.58%	43.48%	45.96%	48.11%
7	0.53%	0.77%	1.01%	1.33%	1.64%	2.06%	2.47%	2.88%	3.21%	3.98%	7.51%	12.26%	17.96%	25.22%	30.09%	41.06%	48.67%	51.27%	53.53%
8	0.66%	0.96%	1.25%	1.58%	1.92%	2.38%	2.84%	3.31%	3.68%	4.58%	8.45%	13.81%	20.09%	27.98%	33.18%	45.14%	53.34%	56.02%	58.35%
9	0.79%	1.15%	1.51%	1.85%	2.20%	2.70%	3.21%	3.72%	4.13%	5.18%	9.34%	15.28%	22.08%	30.51%	36.04%	48.86%	57.53%	60.25%	62.62%
10	0.94%	1.36%	1.79%	2.13%	2.48%	3.03%	3.58%	4.13%	4.58%	5.76%	10.18%	16.67%	23.95%	32.80%	38.66%	52.23%	61.27%	64.01%	66.40%
11	1.09%	1.58%	2.08%	2.42%	2.76%	3.35%	3.94%	4.53%	5.01%	6.33%	10.96%	17.98%	25.70%	34.87%	41.07%	55.27%	64.58%	67.32%	69.71%
12	1.24%	1.81%	2.38%	2.72%	3.05%	3.68%	4.30%	4.92%	5.43%	6.88%	11.69%	19.21%	27.34%	36.74%	43.28%	58.01%	67.50%	70.22%	72.60%
13	1.40%	2.05%	2.69%	3.02%	3.35%	4.00%	4.65%	5.31%	5.84%	7.42%	12.36%	20.36%	28.86%	38.40%	45.30%	60.46%	70.05%	72.75%	75.12%
14	1.57%	2.29%	3.01%	3.33%	3.64%	4.32%	5.01%	5.69%	6.25%	7.93%	12.99%	21.44%	30.28%	39.89%	47.14%	62.64%	72.25%	74.94%	77.30%
15	1.73%	2.53%	3.34%	3.64%	3.94%	4.65%	5.36%	6.06%	6.64%	8.43%	13.57%	22.43%	31.59%	41.20%	48.82%	64.59%	74.13%	76.81%	79.17%
	aaa	aa+	aa	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b	b-	ccc+	ccc	ccc-

Source: Best’s Idealized Default Matrix published Dec. 5, 2007.

ment of interest or principal in a given scenario is recorded as a default. The default probability – number of defaults divided by the number of scenarios – is tabulated and compared with *Best's Idealized Default Matrix*, shown in **Exhibit 5**.

Stress Scenarios

The most important factor that A.M. Best stresses in the SN/ITP CDO is the default rates of the issuing entities – both insurers and non-insurers. Recoveries are assumed to be zero as discussed earlier. The following is a partial list of some of the stress scenarios applied to the transaction:

- Ratings of issuing entities with negative outlooks or that are on negative watch are downgraded one to two notches.
- Ratings of entities with ratings below investment grade are defaulted.
- Default rates are increased by up to 100% – in times of a precipitous decline in GDP, a steep increase in default probability may be warranted, since there is a strong correlation between GDP and impairments as shown by *Best's Impairment Rate and Rating Transition Study*.



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