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M E M O R A N D U M

To: Julian Hammar, CFTC Assistant General Counsel
Date: November 12, 2010
From: Carl B. Wilkerson
Subject: Response to CFTC Inquiry Whether A.M. Best Ratings Consider Leverage

During the November 8, 2010 meeting between representatives of the life insurance industry and the staff of the CFTC and the SEC, the CFTC staff asked whether the ratings provided by A.M. Best consider an entity's leverage. We have provided information below from A.M. Best documentation that addresses this question. Please let me know if you have any further questions on this matter. Thank you.

[Extracted without editing from Best's Credit Rating Methodology]
(http://www.ambest.com/ratings/methodology/bcrm.pdf)

In determining a company's ability to meet its current and ongoing senior obligations, the most important area to evaluate is its balance sheet strength. An analysis of a company's underwriting, financial, operating and asset leverage is very important in assessing its overall balance sheet strength.

Balance sheet strength measures the exposure of a company's surplus to its operating and financial practices. A highly leveraged or poorly capitalized company can show a high return on equity/surplus, but may be exposed to a high risk of instability. Conservative leverage or capitalization enables an insurer to better withstand catastrophes, unexpected losses and adverse changes in underwriting results, fluctuating investment returns or investment losses, and changes in regulatory or economic conditions.[1]

A.M. Best reviews a company's ***financial leverage*** in conjunction with its underwriting leverage[2] in forming an overall opinion of a company's balance sheet strength. Financial leverage through debt or

[1] A.M. Best's assessment of balance sheet strength includes an analysis of an organization's regulatory filings, including the GAAP or IFRS balance sheet, at the operating insurance company, holding company, and consolidated levels. To assess the financial strength and financial flexibility of a rated entity, a variety of balance sheet, income statement, and cash flow metrics are reviewed, including corporate capital structure, financial leverage, interest expense coverage, cash coverage, liquidity, capital generation, and historical sources and uses of capital.

[2] Underwriting leverage is generated from current premium writings, annuity deposits, reinsurance and loss or policy reserves. A.M. Best reviews these forms of leverage to analyze changes in trends and magnitudes. To measure exposure to pricing errors in its book of business, we review the ratio of gross and net premiums written to capital. To measure credit exposure and dependence on reinsurance, we review the credit quality of a company's reinsurers and ratio of reinsurance premiums and reserves ceded and related reinsurance recoverables to surplus. To measure exposure to unpaid obligations, unearned premiums and exposure to reserving errors, we analyze the ratio of net liabilities to surplus. In order to assess whether or not a company's underwriting leverage is prudent, a number of factors unique to the company are taken into

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debt-like instruments (including financial reinsurance) may place a call on an insurer's earnings and strain its cash flow. Similar to underwriting leverage, excessive financial leverage at the operating or holding company can lead to financial instability. As such, the analysis is conducted both at the operating company and holding company levels, if applicable.

To supplement its assessment of financial leverage, A.M. Best also reviews a company's ***operating leverage***. 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 are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on an insurer's earnings and cash flow. In other words, the residual risk to the insurer would be insignificant as long as the insurer possesses sound asset/liability, liquidity and investment risk management capabilities; exhibits low duration mismatches; and minimizes repayment and liquidity risk relative to these obligations. Best has established specific tolerances for operating leverage activities that are applied at each operating company, as well as at the consolidated level. Generally, debt obligations viewed by A.M. Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

A.M. Best also evaluates ***asset leverage***, which measures the exposure of a company's surplus to investment, interest rate and credit risks. Investment and interest rate risks measure the credit quality and volatility associated with the company's investment portfolio and the potential impact on its balance sheet strength. A company's underwriting, financial and asset leverage is also subjected to an evaluation by Best's Capital Adequacy Ratio (BCAR) which calculates the net required capital to support the financial risks of the company. This encompasses the exposure of its investments, assets and underwriting to adverse economic and market conditions such as a rise in interest rates, decline in the equity markets and above-normal catastrophes. This integrated stress analysis evaluation permits a more discerning view of a company's relative balance sheet strength compared to its operating risks. The BCAR is based on audited financial statements and supplemental information provided by companies. The BCAR result is an important component in determining a company's balance sheet strength. A.M. Best also views insurance groups on a consolidated basis and assigns a common BCAR result to group consolidations or multiple member companies that are linked together through intercompany pooling or reinsurance arrangements.[3]

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consideration. These factors include type of business written, spread of risk, quality and appropriateness of its reinsurance program, quality and diversification of assets, and adequacy of loss reserves.

[3] There are other barometers of leverage that may be of interest to the CFTC or SEC staff concerning evaluation of this issue. The prudential regulator's definition of leverage may be the most relevant basis for identifying "highly leveraged" participants in the derivatives market. For many bank holding companies, asset managers and finance companies, it is common practice to use a simple ratio of capital to assets. For life insurers, however, the National Association of Insurance Commissioners has already established an effective leverage metric, the Risk-Based Capital Ratio (RBC ratio). The RBC ratio is used by state insurance regulators to identify weak, leveraged insurance companies and determine a course of remediation, including potentially assuming control of the insurer for the benefit of policyholders. These numbers are readily available, from the 5-year historical data exhibits of each insurer's statutory annual statements. Life insurers must hold statutory capital equal to at least 200% of the "authorized control level" of capital. Capital adequacy measurement is by definition a complex exercise. It would be in the interest of regulators to make use of an established, consistent metric rather than to introduce a calculation procedure that has not already been applied successfully across the insurance sector.