A.M. BEST

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Commercial Paper Methodology

A.M. Best's Perspective

Commercial paper issuance has been and will continue to be a significant source of short-term funds for many insurance companies. Despite the presence of a few questionable credits, the confidence and liquidity of the commercial paper market is strong. With insurers relying heavily on commercial paper for short-term funding, an analysis of short-term liquidity is vital as it addresses the short-term financial survival of an enterprise and is completed in combination with the assessment of the long-term solvency of an enterprise.

A.M. Best's rating process for commercial paper analyzes a company's capacity to generate cash to service obligations, and assesses the variety, availability and stability of alternative sources of liquidity. The analysis focuses on all short-term debt obligations—those with a term of one year or less. Short-term debt ratings address the likelihood of default, while long-term debt ratings address both the likelihood and severity of default.

The short maturities of commercial paper programs imply less flexibility and greater urgency in dealing with new and unexpected financing needs. As demonstrated in the General American liquidity crisis, a firm's capital or solvency does not necessarily protect it against financial distress. Rather, a lack of liquidity and alternate funding sources can lead to bankruptcy, regardless of market share, profitability or financial leverage.

A.M. Best's analysis applies both qualitative and quantitative factors in determining internal and external sources used to protect insurers' liquidity requirements. This includes the entire basket of cash and near-term sources of cash such as marketable securities, plus any external liquidity arrangements (e.g., bank facilities).

While commercial paper may have an initial maturity as long as 270 days, many issuers stick to the 30-day-and-under maturity range. Due to the short maturity of this security, issuers must continually refinance a significant amount of maturing commercial paper each month. An individual issuer may repay maturing paper with funds generated from operations, or by the sale of invested assets. However, the bulk of the maturing paper is paid off when the issuer sells new paper to obtain additional funds (i.e., rolls the maturing paper).

This can create a risk for both the issuer and the investor. As previously noted, an adverse turn of events might make it extremely expensive, if not impossible to roll maturing paper. To reduce the risk to the investor, issuers now support their outstanding paper with bank lines of credit, a practice which began after Penn Central Railway Company went bankrupt in 1970 with $82 million in commercial paper outstanding.

The supply of traditional bank credit facilities can ebb and flow with the credit appetites of even the largest banks. The Basel Accord has proposed additional regulation regarding capital adequacy requirements for banks, which may impact 364-day credit facilities that currently enjoy capital-free status. Additional capital adequacy would in all likelihood lead to rising costs for issuers. All of this comes at a time when most insurance companies, regardless of business, continue to implement significant expense reduction programs. A potential consequence of additional regulation would be a reduction of bank credit lines supporting commercial paper programs. This would lead to increased risk in the commercial paper market.

A.M. Best's rating analysis for commercial paper requires a review of an issuer's overall liquidity risk, incorporating all near-term claims on cash, both direct and contingent, for all rated entities within its group whether or not commercial paper financing is used. Detailed quantitative and qualitative considerations are necessary since issurers' ability to generate immediate and near-term cash flow can vary significantly among industry sectors and from company to company. In addition, short-term cash flow requirements in a normal or stressful business environment differ greatly, depending on the type of insurance, lines of business and market share. Predetermined liquidity calculations are avoided due to these significant differences. An issuer-by-issuer approach is vital, entailing a careful review of liquidity needs and sources, market conditions and contingency plans.

To properly assess the short-term funding risk of any insurer requires an in-depth dialogue and understanding of the relevant issues between the A.M. Best analyst and the management of the rated insurer.

Rating Methodology

A.M. Best's ratings of commercial paper issued by organizations in the insurance industry provide the credit marketplace with an opinion of an issuer's ability and willingness to meet short-term financial obligations to security holders when due.

The analysis of an issuer's short-term creditworthiness includes a careful assessment of its liability structure, the array of short-term and maturing obligations, the maturity profile of invested assets and the correlation to market risk. The purpose is to assess the magnitude of potential commercial paper and other short-term obligations, which the company's alternative liquidity arrangements may be required to fund. In evaluating an issuer's liquidity risk, the potential near-term obligations of the issuer are considered and compared to all likely near-term cash sources. Outstanding commercial paper is a component of near-term obligations, while bank credit facilities are viewed as a component of the potential near-term cash sources.

Issuer Specific Analysis

A.M. Best's analysis begins with a critical evaluation of an insurer's sources and uses of cash. In order to assess the company's ability to meet both operating needs and debt obligations, an analysis of a series of reasonable stress scenarios is then performed. Next, contingency funding plans for a sustained period of stress, caused by either company-specific concerns or general market disruption, is examined. General market disruptions can be caused by catastrophe claims following an earthquake or hurricane, by a "run on the bank" following a rating downgrade (e.g., General American) or by a volatile stock market.

Tight money has, at times, also created difficulties for issuers lacking a strong credit rating. In today's market environment, all commercial paper programs are required to be backed by bank lines of credit or an alternate liquidity instrument.

A.M. Best notes that property and casualty companies are largely uncorrelated with market risk since short-term liquidity would likely be triggered by event risks. Life insurance companies, specifically annuity writers, have a higher correlation with market risk as their products carry interest rate risk.In either case, the ability to access short-term funding is crucial in determining a company's short-term debt rating.

Liquidity Analysis

The starting point in liquidity analysis is the assessment of an insurer's potential liquidity. The issuer should demonstrate that it can smoothly accommodate the loss of confidence-sensitive funding under stress conditions without disrupting its basic business plan. Although there have been very few defaults among rated commercial paper issuers, an adverse turn of events might make it extremely expensive or even impossible for the issuer to sell new paper to pay off maturing paper. In addition, a company in distress could quickly lose access to external sources, namely bank credit lines, due to default provisions or other agreement provisions.

Therefore, a thorough understanding of each issuer's liquidity profile should be considered in the context of immediacy, quality and diversity:

- Review all short-term funding sources—commercial paper, master note programs, money market bank loans—and determine all global short-term security markets utilized by the issuer.
- Discuss management's philosophical approach and track record with regard to liquidity, financial flexibility, minimum cash position, reasons for short-term borrowings and how it fits into an insurer's overall funding strategies.
- Evaluate the degree of dependence and sources of liquidity.
- Review the loyalty and financial strength of banking relationships.
- Ascertain the degree of volatility of the company's cash flow.
- Discuss stress scenarios and contingency plans should commercial paper and similar funding suddenly become unavailable.
- Determine the overall financial leverage and the ability to repay short-term debt with long-term obligations.

Internal Sources of Liquidity

Cash-on-Hand

In evaluating an insurer's cash-on-hand, consider:

- Currencies in which an insurer invests.
- Possible complications related to cross border repatriation, currency conversion, tax issues, regulatory concerns and sovereign risks.

Near-Term Cash Assets

In evaluating an insurer's near-term cash assets, consider:

- Investment portfolio liquidity, by type of investment.
- Operating cash flow.
- Dividend capacity of subsidiaries.
- Timing for conversion to cash/immediacy of availability.
- Possible value implications for liquidation in a stress situation.
- Strength and availability of cash flow.
- Assets that may already be pledged or assets with springing liens.

External Sources of Liquidity

Bank Credit Facilities

In assessing an insurer's bank credit facilities, consider both quantity and quality. Bilateral lines or facilities syndicated with very few banks are viewed as an unwarranted risk. High participation levels in a syndicated credit facility could lead to majority control by a few banks. This could work against a company in stressful situations when amendments or waivers are required to avoid default.

Alternate liquidity is also examined to ensure that swing lines are available for coverage on commercial paper issued in each paying agent city. The size and availability of the commitment are very important. Documentation of credit facilities is carefully reviewed to determine the level of flexibility a company is allowed within the provisions. These include covenants, material adverse change (MAC) clauses, events of default, cross default and cross acceleration, maturity date, conditions of funding, changes in control or management and renewal procedures for multiyear or 364-day revolving credits. Borrowing options should include same-day funding, as a company might need same-day funds to rollover maturing commercial paper. Also considered are the financial strength of the lenders and relationship factors.

Due consideration is given to contractually committed bank lines compared with an uncommitted credit facility such as advised and/or guidance facilities, which can be withdrawn by the lender at will. A.M. Best places greater value on relationship-based, committed bank facilities in comparison to transactional or arms-length arrangements.

Letters of Credit

While not prevalent among insurance companies, a number of firms enhance their liquidity by issuing commercial paper backed by a letter of credit (LOC) from a bank. To provide true liquidity, the LOC has to be an irrevocable and unconditional guarantee that will pay off all commercial paper at maturity in all cases. However, while the LOC provides current liquidity to the company, the credit risk is borne by the bank and not the issuer. In such cases, A.M. Best would rate the commercial paper program higher than the short-term debt rating because of the third party credit-enhancement feature.

Evaluating Total Cash Flows

The analysis, which starts with potential claims on cash, considers the amount of surplus cash flow available to meet maturing commercial paper, particularly at peak borrowing periods. The analysis also includes operating uses of cash, the maturity profile of debt obligations or other financial claims that could become payable, and contingencies.

The maturity profile considers the amounts and dates for payment of direct obligations, along with the maturity dates of credit facilities. The first step, however, is to take a broad look at all potential claims on cash.

Potential Near-Term Claims on Cash

Direct Obligations

- Short-term debt.
- Current portion of long-term debt.
- Capitalized lease obligations.
- Contingent obligations.
- Funding arrangements.
- Financial and commodity derivatives contracts.
- Off balance sheet financing obligations.
- Litigation or judgements.
- Margin requirements.

Other Claims on Cash

- Working capital.
- Capital spending commitments.
- Stock buyback.

Rating Scale

The evaluation of an issuer's commercial paper and other short-term debt issues reflects A.M. Best's opinion of the issuer's fundamental credit quality. The analytical approach is virtually identical to the one followed in assigning a long-term rating, and a strong link exists between the short-term and long-term rating. However, knowing the long-term rating will not fully determine a commercial paper rating because of the overlap in rating categories.

AMB-1+

Cash, liquid assets and alternate sources of liquidity should be superior, with any commercial paper program having backup lines of credit supporting at least 75% of the program.

Issuers accorded an AMB-1+ rating are distinguished by an exceptional ability to repay short-term debt obligations. Characteristics of this rating category include an exceptional corporate strategy and financial management, as well as significant liquidity and financial flexibility. Issuers are market leaders in their core business operations. Management's strategy ensures strong earnings and sustainable operating trends. Financial management is conservative with low debt-to-capital and excellent fixed-charge coverage ratios. Significant liquidity is available internally from a diverse earnings base, as well as from excess cash available on the company's balance sheet. External sources of liquidity include committed bank lines of credit and multiple access to cash through the capital markets.

AMB-1

Cash, liquid assets and alternate sources of liquidity should be strong with any commercial paper program having at least 90% backup lines of credit.

Issuers rated AMB-1 exhibit a strong ability to repay short-term debt obligations. Most credit issues discussed in AMB-1+ will be similar to AMB-1 with slightly less strengths. Issuers in this rating category will have a strong capability to service short-term debt. Fixed charge coverage, liquidity and capital structure could exhibit more variability because the company's strategy would make it less of a market leader and more susceptible to outside factors. However, the issuer must still display superior access to the capital markets and have significant alternative liquidity available to repay short-term debt obligations.

AMB-2

Cash, liquid assets and alternate sources of liquidity should be acceptable, with any commercial paper program having backup lines of credit supporting 100% of the program.

Issuers rated AMB-2 exhibit an acceptable ability to repay short-term debt obligations. While alternative liquidity remains adequate, companies in this category have a weak franchise and therefore have more variability in earnings, cash flow and fixed charge coverage. Companies with a fragile market position cannot consistently rely on the capital markets to fulfill liquidity needs. Issuers rated AMB-2 have only an acceptable ability to service short-term debt. However, adequate alternate liquidity protection is maintained.

AMB-3

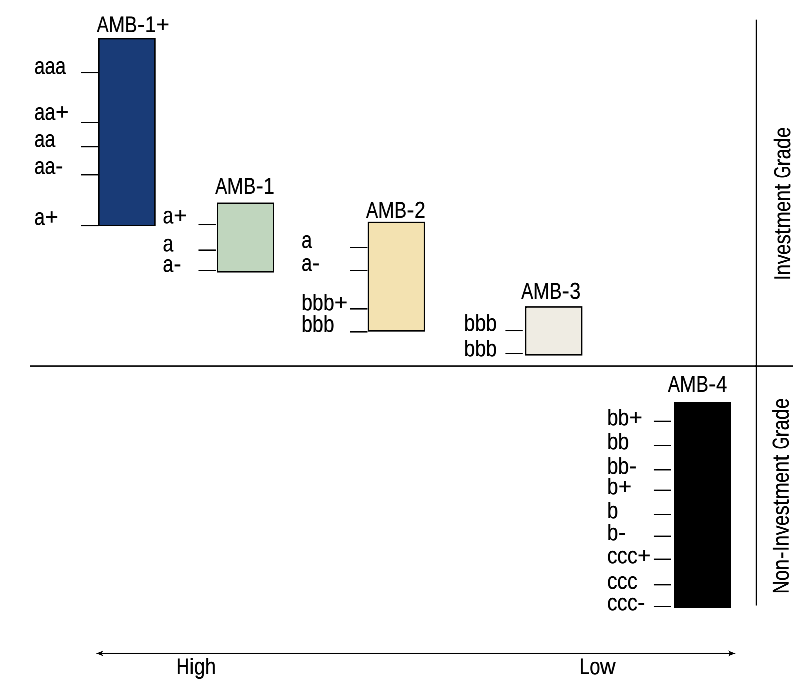
Even though the credit market conditions may be very positive, the market for this paper would be limited to only a few investors.

AMB-4

Correlates to the speculative long-term rating category. The commercial paper market will not accept insurers, or any other industries, with this rating.

A.M. Best Commercial Paper Ratings

Correlation of commercial paper ratings with long-term debt ratings.



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