Article Title: Criteria | Insurance | Specialty: Debt Tranching And Ratings Caps In Global Insurance Securitization Data: (EDITOR'S NOTE: —On April 1, 2020, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) These criteria relating to the tranching of debt and capping of ratings in insurance securitization structures aid transparency in the ratings process. In the context of tranching, these criteria focus on the circumstances that make it feasible to assign differential ratings to debt issued in a single transaction, yet subdivided into multiple classes of notes, and on the circumstances where a single rated class may be more appropriate. Capping of ratings is used to limit the rating levels on the most senior notes to be issued in a structure. In this article we clarify our approach to rating notes backed by different insurance products and in particular we identify the circumstances where multiple classes of notes could benefit or restrict the ratings on the notes depending on a structure's proximity to regulatory intervention. The product-specific considerations influencing caps on the ratings are also described for a range of insurance securitizations. Tranching For most securitizations, it is a relatively straightforward task to depend on the modeled credit risks from a pool of assets to tranche the various classes of notes according to the priority of their rights to the cash flows or to their proximity to risk of default of the assets. Multiple classes are, however, less common in insurance securitizations than in many other sectors because the sensitivity of policyholder interests has to be considered. Any structure which ignores the interests of the underlying insurer's own policyholders will likely fall foul of the insurance regulators, who have the power to override even the most painstakingly constructed securitization agreements. A significant issue for us when considering multiple classes of insurance-backed notes is whether contractual arrangements designed to facilitate tranched debt may inadvertently risk undermining the integrity of the structure and its ability to function as intended. In particular, there is a risk of overestimating the generation of cash flows that can be channeled to notes intended to carry the best rating. An excess of cash channeled to one class of noteholders can have an adverse effect on long-term policyholders in addition to the subordinated noteholders. This consideration needs to be factored into the market-oriented objective of tranching securitized debt so as to achieve the best match between investor appetite for risk at a given tenor and the amount of debt to be raised relative to the underlying issuer's needs. We cannot ignore the interests of policyholders. If the effect of tranching is to "squeeze out" cash flows in the early years for the benefit of shorter term, potentially higher rated notes, then cash flows may not remain sufficient in later years to service the claims of the underlying insurer's own long-term policyholders. While the ratings on subordinated and longer dated notes reflect their greater risk, prudential checks and balances are also required to ensure that policyholder interests are protected throughout the life of a securitized insurance structure as well as under all reasonable stressed scenarios. In principle, if we have concerns that the very issuance of two differentially rated classes could precipitate regulatory intervention leading to default on all the notes, we would view the tranching as having no positive effect on the structure and would rate all the notes the same; at the lower of the rating levels. In other words, different classes, irrespective of their tenor, would carry the same rating. Differentiated ratings may still exist if longer dated notes are present in the structure or if specially structured notes are introduced to avoid contagion of the higher rated notes and the increased risk to these notes is made explicit and explained at length in our presale report. Caps On Ratings Caps on catastrophe bonds This section has been deleted because it was superseded (see "Methodology And Assumptions For Insurance-Linked Securitizations," Nov. 19, 2018.) Caps on notes in embedded value securitizations Capping also has a further application over and above the indication of uncertainty regarding the timing, severity, and likely total losses associated with catastrophe bonds. In life insurance embedded value securitizations, where the underlying risk is often granular, ratings may often be capped at the rating level of the underlying insurer when the smooth functioning of the structure and the servicing of the notes depends on the insurer's ongoing financial strength. This dependence may be operational in the sense that the insurer (or successor if the weak insurer is acquired or a back-up run-off administrator is appointed) needs to continue to operate in order to administer the securitized assets, usually a pool of insurance contracts, which underpin the structure. However, dependence may also take more subtle forms. As the potential for regulatory intervention is possible at any point during the long tenor of the notes backed by blocks of life insurance policies, we would set a cap corresponding to the underlying insurer's own financial strength rating (FSR). In certain

circumstances it may furthermore be determined that the notes must be rated at least one notch lower than the insurer's FSR, implying both dependence and de facto subordination of even the most senior of the securitized notes. As a visual aide the matrix below segments certain common insurer, consumer, and corporate protection products using the twin criteria of strong granularity and low potential for exposure to regulatory risk through prejudice to the long-term interests of policyholders. Qualifying products that display strong granularity and a low probability of regulatory risk can, in general, be considered suitable for both securitization and multi-tranching of the ensuing ratings. However, the other dependent risk factors associated with the ratings caps would still need to be considered by us in forming a ratings opinion. Regulation issues With any insurance securitization, therefore, the symmetries and certainties of mathematical modeling must often give way, at least in part, to the unpredictability and occasional irrationality of the regulatory framework. In nearly all countries, insurance is a formally regulated activity, as is reinsurance in markets such as the U.K. and the U.S. As a consequence of such regulation, it no longer suffices simply to pose the question "can the cash flows be modeled"? It becomes equally important to ask and have answered the supplementary question, "will the regulator consider this mechanism as a strengthening or a weakening of the insurer's ability to reimburse the legitimate claims of its policyholders"? If supportive of the ability to pay claims, then the structure is likely to be tolerated or even welcomed by the regulator who ought to have no reason to intervene in the operation of the structure in an arbitrary or disruptive manner. Moreover, during periods of financial stress, the regulator may actually support the smooth functioning of the structure to the extent that it may be deemed equivalent to supplementary funding or reinsurance for the regulated entity. We seek to ensure that "first dollar" default expectations are clear and that counterparties understand whether they are senior or subordinated to other claimants and whether the receipt of interest and principal is subject to regulatory as well as to contractually mitigated structural risks. However, in those circumstances where the regulatory risk may become paramount, it is almost always deemed appropriate to apply a cap to the ratings in an insurance structure. Types of insurance securitizations In summary, we have identified four distinct types of treatment of insurance securitization and the corresponding cap guideline. In practice, however, real structures may display various combinations of treatment: Transaction structures that are clearly supportive of an insurer's ability to pay all policyholder claims. Regulatory risk is minimal and ratings may potentially be assigned at the highest levels on the rating scale subject only to any caps resulting from uncertainties surrounding the timing or severity of losses to noteholders, as in the case of insurer protection products. Transaction structures that may interfere with an insurer's ability to pay some or all of its future claims. Regulatory intervention risk is high and the structure must either be amended, abandoned, or, at the very least, rated at a level that is capped below the FSR on the underlying insurer as the FSR is itself indicative of our expectation of the likelihood of the insurer being taken into regulatory administration due to insolvency. Tranching may be considered, but almost certainly downwards from the insurer's FSR and not upwards above it. Transaction structures that depend on the ongoing solvency of the underlying insurer. If, for example, for administrative purposes the underlying insurer needs to continue to function in order to service the securitized policies, then the ratings on the notes under the structure would normally be capped at or below the FSR on the insurer. As with (ii), only downwards tranching from the insurer's FSR would normally be considered. Transaction structures that are independent of the ongoing solvency of the underlying insurer. Any structure that is entirely self-contained and not reliant on or vulnerable to any other party for its effective operation is analyzed and rated potentially to the highest levels on the basis of its own, inherent default probabilities. Tranching across the full range of the rating scale would usually be possible if structurally appropriate. Revisions And Updates This article was originally published on Oct. 6, 2004. Changes introduced after original publication: Following our periodic review completed on March 3, 2015, we updated the contact information Following our periodic review completed on Feb. 29, 2016, we updated the contact information, updated criteria references, and deleted outdated sections that were related to the initial publication of our criteria. Specifically, the section titled "Caps on catastrophe bonds" was moved to an appendix of this article, as it was superseded by the article titled "Methodology And Assumptions For Rating Natural Catastrophe Bonds," published on May 12, 2009, which was itself superseded by "Rating Natural Peril Catastrophe Bonds: Methodology And Assumptions," published

Dec. 18, 2013. Following our periodic review completed on Feb. 24, 2017, we deleted commentary. Following our periodic review completed on Feb. 20, 2018, we updated the contact information and "Related Criteria" section, deleted superseded criteria text that had previously been moved to an appendix, and deleted commentary that had previously been moved to the "Revisions And Updates" section. On April 16, 2019, we republished this criteria article to make nonmaterial changes. We updated the contact information and criteria references. On April 1, 2020, we republished this criteria article to make nonmaterial changes to update the contact information. Related Criteria And Research Related Criteria Methodology And Assumptions For Insurance-Linked Securitizations, Nov. 19, 2018 Regulation XXX Structured Solutions, Dec. 15, 2004 These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by issuer- or issue-specific attributes as well as S&P; Global Ratings assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions may change from time to time as a result of market and economic conditions, issuer- or issue-specific factors, or new empirical evidence that would affect our credit judgment.