Article Title: ARCHIVE | Criteria | Insurance | General: Recovery Ratings On The Debt Of Speculative-Grade Companies In The Insurance Sector Data: (EDITOR'S NOTE: — This criteria article is no longer current. It has been superseded by the article titled, "Key Credit Factors For The Business And Consumer Services Industry," published on Nov. 19, 2013.) Standard & Poor's Ratings Services has been assigning recovery ratings--estimates of post-default recovery that are specific to debt instruments--to the debt of speculative-grade industrial companies since December 2003. In 2007, we began expanding our recovery analysis to the debt of certain speculative-grade U.S. insurance organizations. As of May 30, 2008, Standard & Poor's had recovery ratings on debt instruments issued by 21 companies operating in the insurance sector. Our approach for assigning recovery ratings to companies operating in the U.S. insurance sector has closely mirrored the one we use for industrial companies and other noninsurance sectors (see "Criteria Guidelines for Recovery Ratings On Global Industrials Issuers' Speculative-Grade Debt," last published on Jan. 7, 2008, on RatingsDirect, the real-time, Web-based source for Standard & Poor's credit ratings, research, and risk analysis). Frequently Asked Questions What are recovery ratings? Recovery ratings assess a debt instrument's ultimate prospects for recovery of estimated principal and pre-petition interest (i.e., interest accrued but unpaid at the time of default) given a simulated payment default. Standard & Poor's recovery methodology focuses on estimating the percentage of recovery that debt investors would receive at the end of a formal bankruptcy proceeding or an informal out-of-court restructuring. Lender recoveries could be in the form of cash, debt, or equity securities of a reorganized entity or some combination thereof. We focus on nominal recovery (versus discounted present-value recovery) because we believe that market participants should gauge discounted recovery independently by applying their own preferred discount rate to our nominal recovery. Recovery ratings focus solely on the expected recovery for a specific debt issue in the event of an issuer payment default and are independent of the issuer credit rating, which provides a separate indication of the probability of default. Our recovery analysis is a comprehensive review but consists of three basic components: Determining the most likely path to default for each company. Valuing the company following default. Distributing that value to the various claimants based on their relative priority. We determine relative priority by evaluating the company's debt and organizational structure with regard to borrowers, guarantors, nonguarantors, collateral pledges and exclusions, any intercreditor agreements, and other liabilities. Ultimately, we combine the recovery rating and the issuer credit ratings to arrive at the issue rating based on our notching criteria (described more fully below). Our goal in providing a separate default (issuer credit rating) and recovery (recovery ratings) indicators is to enhance the transparency of our ratings and help debt investors disaggregate these two key the components of credit risk. How has Standard & Poor's focused its recovery ratings for insurance companies? Standard & Poor's assigns recovery ratings only to the debt of speculative-grade entities because an estimate of loss given default is more important for these issuers in light of the increased probability of default. Given the importance of financial strength in the insurance industry, the universe of North American insurance companies with recovery ratings is very limited because more than 90% of such companies have investment-grade counterparty credit ratings. In addition, we do not currently assign recovery ratings to the debt of life insurance or property/casualty insurers because we are unsure how the unique nature of the business model and the high level of regulatory oversight would affect recovery rates. As a result, the recovery ratings we have assigned to insurance-related organizations have been, for the most part, on the obligations of insurance brokers and other service-oriented intermediaries plus a few health plans that do not assume true insurance risk. We continue to investigate the possibility of performing recovery analysis on life and property/casualty insurance organizations. These ratings would need to address the likely impact of state and federal regulations on the insolvency process. However, the low volume of speculative-grade issuers, the limited number of defaults, and a lack of reliable data on recovery for these businesses have hampered these efforts. We intend to refine and publish our criteria for recovery ratings of traditional insurance companies that are subject to regulatory risk in advance of assigning such ratings. The insurance industry is different than other sectors. Why is Standard & Poor's using the same recovery criteria it uses for the industrial sector? When a company isn't assuming true insurance risk, the factors we consider in analyzing the recovery prospects of insurance-related organizations are similar to those of other industry sectors. Nevertheless, our analysis does take into account that the insurance-related issuers we've rated to date do not accumulate significant fixed assets and, as service organizations, are subject to greater earnings volatility. In addition, companies with regulated insurance companies often have cash flow from unregulated subsidiaries, which can be material. What is Standard & Poor's recovery rating scale, and how does this affect ratings in the insurance sector? We rolled out our enhanced recovery scale and issue rating framework in June 2007 (see Table 1). The primary emphasis for issue ratings remains the likelihood of default, which we incorporate into the issuer credit rating. We notch ratings on specific debt issues up or down from the issuer credit rating if the expected recovery for that debt instrument is significantly above the mean historical recovery rate of about 50% for all defaulted debt instruments (according to Standard & Poor's Risk Solutions LossStats® Database from 1987 through September 2007). Issues with a high recovery rating ('1+', '1', or '2') would lead us to rate the loan or bond above the corporate credit rating, while a low recovery rating ('5' or '6') would lead us to rate the issue below the corporate credit rating. Table 1 Recovery Rating Scale And Issue Rating Criteria For Issuers With A Speculative-Grade Corporate Credit Rating RECOVERY RATING RECOVERY DESCRIPTION RECOVERY EXPECTATIONS* ISSUE RATING NOTCHES RELATIVE TO CORPORATE CREDIT RATING 1+ Highest expectation, full recovery 100%¶ +3 notches 1 Very high recovery 90%-100% +2 notches 2 Substantial recovery 70%-90% +1 notch 3 Meaningful recovery 50%-70% 0 notches 4 Average recovery 30%-50% 0 notches *Recovery of principal plus accrued but unpaid interest at the time of default. ¶Very high confidence of full recovery resulting from significant overcollateralization or strong structural features. As noted above, the issuers in this sector with recovery ratings tend to be asset-light, service-oriented organizations and could be vulnerable to material earnings volatility, especially if they are in distress. In addition, insurance-related organizations often secure credit obligations with equity interests in underlying subsidiaries, which provides only an indirect claim against the value of the subsidiary. As a result, the actual value of the collateral for these companies is uncertain, and the problems of the issuer in a bankruptcy scenario might diminish it. Therefore, the actual value of the collateral is subject to greater volatility than if an asset with greater principle protection had secured the instrument. Accordingly, we see limited opportunity for recovery of insurance-related obligations to be assigned a recovery rating of '1+', as this rating requires very high confidence of full recovery because of overcollateralization at default, strong structural protections, or both. In practice, the weak form of collateral and potential earnings and enterprise volatility have generally resulted in low recovery ratings for junior forms of debt, whether they're second-lien or unsecured obligations. What unique steps does Standard & Poor's take in establishing a simulated path to default? As is the case with industrials, the simulated default scenario is our assessment of the borrower's most likely path to a payment default. The insolvency proxy is the point along that path at which we expect the borrower to default. In other words, the insolvency proxy is the point at which funds available and free cash flow can't cover fixed charges. Conversely, free cash flow could decline below the insolvency proxy when cyclicality or business-model contraction results in continued deterioration of the borrower's operating performance beyond the initial problem. To date, this has been most noteworthy in our analysis of insurance brokers, for which business reputation and maintaining customer relationships are critical and, if compromised, can contribute to more significant cash-flow declines than one might initially expect. As such, we modeled the alternative case with a drop in EBIDTA beyond the default proxy cash flow to apply the franchise value multiple on. How does Standard & Poor's determine the valuation of insurance-related organizations? Valuing an insurance-sector company constitutes the same critical component in default and recovery analysis as it is for other business sectors because, along with cash-flow declines, it is the foundation of evaluating recovery prospects. Our industry experience indicates that the market-multiples valuation approach is the most appropriate because this is how investors typically value companies in the industry. Although there is a lack of multiples for insurance-related organizations emerging from bankruptcy, transaction-related market multiples are more common and generally form the basis for our default valuations. In this regard, the market multiples we use in the insurance sector recognize characteristics of both the industry subsector and the individual company. That said, we discount the relatively high sector acquisition multiples from recent years to account for the likelihood of additional deterioration because of reputational damage in a bankruptcy scenario. Our industry experience indicates that discrete asset analysis is not a useful valuation methodology for recovery analysis in the insurance-related businesses because in bankruptcy, regulators and other interested parties have recognized the greater value from a reorganization. This perspective also recognizes the normal lack of unencumbered assets available to meet debt obligations and the greater reliance on operating cash flow for these businesses. What are the next steps in Standard & Poor's efforts to expand its assignment of recovery ratings in the insurance sector? In line with our ratings policy, we will continue to assign recovery ratings to companies with unsecured issues or new secured issues. Table 2 shows the insurance-related companies with debt to which we've assigned a recovery rating. Table 2 Insurance Sector Recovery Ratings List As Of June 20, 2008 ISSUER RATING DATE RATED FACILITIES (MIL. $) LOAN RATING RECOVERY RATING COUNTERPARTY CREDIT RATING Alliant Holdings I Inc. Nov. 6, 2007 440 B 2 B-/Stable/-- Amerigroup Corp. April 7, 2007 401 BB+ 2 BB/Stable/-- Amerigroup Corp. April 7, 2007 260 B+ 6 BB/Stable/-- AmWINS Group Inc. Nov. 6, 2007 333 B- 3 B-/Stable/-- AmWINS Group Inc. Nov. 6, 2007 100 CCC 6 B-/Stable/-- Arrowhead General Insurance Agency Inc. May 6, 2008 145 B 2 B-/Negative/-- Arrowhead General Insurance Agency Inc. May 6, 2008 40 CCC 6 B-/Negative/-- Bravo Health Group Inc. Dec. 10, 2007 135 B 4 B/Stable/-- C.G. JCF Corp. Nov. 6, 2007 555 B+ 3 B+/Stable/-- CareMore Holdings Inc. Jan. 20, 2006 150 B 4 B/Stable/-- FHC Health Systems Inc. Oct. 29, 2007 195 B+ 2 B/Stable/-- FHC Health Systems Inc. Oct. 29, 2007 85 CCC+ 6 B/Stable/-- Health Net Inc. April 30, 2008 400 BB+ 3 BB+/Negative/-- HealthCare Partners LLC Oct. 17, 2007 295 BB+ 2 BB/Positive/-- HealthSpring Inc. Sept. 12, 2007 400 BB- 2 B+/Stable/-- Healthways Inc. June 7, 2007 600 BB+ 2 BB/Stable/-- HMSC Corp. April 4, 2007 305 B 3 B/Negative/-- HMSC Corp. April 4, 2007 110 CCC+ 6 B/Negative/-- HUB International Ltd. Nov. 6, 2007 865 B+ 2 B/Stable/-- HVHC Inc. July 12, 2006 185 BB 3 BB/Negative/-- MMM Holdings Inc. June 6, 2008 505 CCC+ 4 CCC+/Positive/-- MultiPlan Inc. Sept. 24, 2007 835 B+ 3 B+/Negative/-- Prodigy Health Group Inc. Nov. 6, 2007 191 B+ 2 B/Negative/-- Prodigy Health Group Inc. Nov. 6, 2007 75 CCC+ 6 B/Negative/-- Prospect Medical Holdings Inc. Feb. 6, 2008 105 B+ 1 B-/Watch Neg/-- Prospect Medical Holdings Inc. Feb. 6, 2008 50 CCC 6 B-/Watch Neg/-- USI Holdings Corp. Feb. 26, 2008 650 B 2 B-/Negative/-- Viant Holdings Inc. (dba Viant) June 7, 2007 325 B+ 2 B/Stable/-- These criteria represent the specific application of fundamental principles that define credit risk and ratings opinions. Their use is determined by the issuer-specific or issue-specific facts, as well as Standard & Poor's assessment of the credit and, if applicable, structural risks for a given issuer or issue rating. Methodology and assumptions change from time to time as a result of market and economic conditions, issue-specific or issuer-specific factors, or new empirical evidence that would affect our credit judgment. 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