Article Title: ARCHIVE | Criteria | Insurance | Bond: Standard & Poor's Reassesses Credit Given For Reinsurance And Soft Capital In Its Bond Insurance Capital Adequacy Model Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled "Criteria | Insurance | Bond: Bond Insurance Industry Overview And Analytical Focus," published on June 29, 2006.) Standard & Poor's Ratings Services last reassessed the credit that monoline bond insurers and reinsurers receive relating to their use of reinsurance and other forms of third-party supplied capital ("soft capital") nearly 10 years ago. Since then, significant change has occurred with regard to analytic tools and techniques for assessing risk, soft capital products available, and reinsurance industry dynamics and performance. As a result, Standard & Poor's has completed a review of soft capital criteria as a component of its review of the bond insurance capital adequacy model. Other aspects of the model are currently under review and we expect to announce our conclusions later this year. Traditional Reinsurance Summary Credit given for reinsurance from monoline reinsurers includes the following changes: For 'AAA' rated ceding companies--greater credit for 'A' rated reinsurers. For 'AA' rated ceding companies--reduced credit for 'AA' rated reinsurers and greater credit for 'A' and 'BBB' rated reinsurers. For 'A' rated ceding companies--reduced credit for 'AA' and 'A' rated reinsurers. Credit for reinsurance from multiline reinsurers set at five percentage points lower than the monoline reinsurer scale. No credit for any reinsurer that does not have a financial enhancement rating (FER). For monoline bond insurers and reinsurers, Standard & Poor's has historically given varying amounts of credit for reinsurance in its capital adequacy model based on the rating of the reinsurer and the ceding company. This credit was not sensitive to whether the reinsurer was a monoline or multiline company or whether the reinsurer had demonstrated an unqualified and unquestioned willingness to meet its financial guarantee obligations on a timely basis. In the past few years, as part of our capital adequacy modeling, the amount of credit given to a particular reinsurer has generated the most questions and comments. Focus on this particular aspect of our criteria increased within the past year following our initial outlook change to "Negative" on the entire monoline financial guarantee reinsurance industry in March 2002, and our subsequent lowering of certain of this industry's participant's ratings. At the same time, powerful analytic tools have become available that facilitate a more rigorous analysis to determine the appropriate credit that should be given to reinsurers in our modeling. Our re-examination of the appropriate credit to be given for reinsurance support examined and analyzed several factors that could be determinative in establishing this credit. These factors included the reinsurer's rating, the ceding company's rating, the tenor of the business ceded to reinsurers, the correlation among the various reinsurers, the small pool of reinsurance providers actively serving the industry, and the diversity of types of reinsurers. To assist us, we made use of Standard & Poor's CDO Evaluator, a powerful analytic tool to evaluate pools of risk that makes use of the Monte Carlo simulation methodology and takes into account default probabilities, correlations, and concentrations. To enhance transparency and understanding and to make the credit methodology user-friendly, we have established the following reinsurance credit table for business ceded to a monoline reinsurer. Table 1 Reinsurance Credit For Business Ceded To A Monoline Reinsurer (%) —MONOLINE REINSURER RATING— AAA AA A BBB CEDING COMPANY RATING AAA 100 70 50 N/A AA 100 75 70 50 A 100 80 75 70 N/A—Not applicable. In the course of conducting our analysis, certain elements proved to be more powerful in shaping the final outcome. After the reinsurer's rating, which by definition should be an important factor, and the ceding company's rating, which defines the level of certainty of performance desired, it was the facts that the pool of monoline reinsurers is quite concentrated in terms of numbers of active participants and that this group is highly correlated that had the most influence on the outcome. The CDO Evaluator proved to be particularly useful in conducting this part of the analysis. We also examined the effect of having both monoline and multiline companies in the mix of reinsurers. As might be expected, adding a measure of diversity to the reinsurer pool was beneficial to the analysis. The effect was minimal, however, because the total number of reinsurers was still small and the diversity of the pool was still limited compared to pools of counterparties spread across multiple sectors. Also, the tenor of the reinsured risks was not a determinative factor because it was consistent from reinsurer to reinsurer and not materially different from that of the ceding company. The minimal benefit of the greater diversity achieved by introducing multiline reinsurers into the mix is outweighed by the twin realities that the ratings of multiline insurers and reinsurers are less durable than those of the monolines and that the multiline reinsurers have a checkered history of participation in the financial guarantee sector. Over the past several years, Standard & Poor's has observed that on occasion, but particularly when the monetary amounts are significant, multiline insurers that write financial guarantee insurance as a minor component of their broad product line will handle claims as they would a claim from any of their other lines of business. This process is characterized by a propensity to investigate first, then negotiate, and finally pay the negotiated claim. While this practice is standard operating procedure in most lines of insurance, it fails to meet the needs of the financial guarantee investors, which comprise a market that requires timely payment in the event of a claim. Reflecting these realities, the credit for multiline reinsurers will be five percentage points lower than the credit given to comparably rated monoline reinsurers. The various credits are shown in the following table. Table 2 Reinsurance Credit For Business Ceded To A Multiline Reinsurer (%) —MULTILINE REINSURER RATING— AAA AA A BBB CEDING COMPANY RATING AAA 95 65 45 N/A AA 95 70 65 45 A 95 75 70 65 N/A—Not applicable. Finally, for financial guarantee insurers to be able to pay claims in a timely manner, they must receive full and timely payment of any claims from their reinsurers. Bond insurers are not, nor should they be, capitalized to be, in effect, a liquidity resource for the reinsurer. Reinsurers that qualify for and receive an FER are viewed by Standard & Poor's as willing and able to make timely payment and therefore will receive credit as stated above in our capital model. Conversely, reinsurers that have not demonstrated willingness to make full and timely payment through receipt of an FER will receive no credit in the model. Standard & Poor's introduced the FER in May 2000 to meet the market's need to differentiate among insurers as to which ones can be expected to pay financial guarantee claims on a timely basis. FERs are assigned only to insurers that request the rating and meet stringent criteria that identify the insurer's capacity and willingness to pay claims on a timely basis. Bank Lines And LOCs, Capital Support From Third Parties, And Parental Support Summary For banks that are soft capital providers, use the same percentage credit as given for multiline reinsurers with FER ratings. For FER-rated multiline insurers that provide capital support, use the same percentage credit as given for multiline reinsurers that provide traditional reinsurance. For bank- and multiline-provided loss coverage facilities, the full amount of losses covered plus losses retained by the ceding company up to the attachment point must be no more than 80% of total projected losses. For parent companies that provide committed capital, use the same percentage credit as given for monoline reinsurers. For many years, banks have been active providers of soft capital facilities that cover losses up to a certain specified amount in the event that an insurer's losses exceed an attachment point. The attachment point identifies the point at which losses are no longer retained by the ceding company, but instead are covered by the bank (or reinsurer) providing this type of coverage. Attachment points are typically set to correspond to a severe loss scenario. Although there have not been any draws on this type of facility by a bond insurer, the overall history of banks funding draws on lines or LOCs is quite favorable. This suggests that bank performance on these soft capital facilities should be the same as is expected from insurance companies with FERs. The willingness component of the FER is mirrored in banks by virtue of their long and favorable history of performance, and by the fact that a failure to perform could trigger credit events under other bank products. On the other hand, banks offering these facilities share two negative characteristics with multiline insurers in that the ratings on banks are also less durable than those of the monolines and that some banks have shown a propensity to change business strategy from time to time, resulting in decisions to cease offering these products. Therefore, credit for bank lines and LOCs will be the same as given for multiline reinsurers with FERs. Multiline reinsurers providing similar products will receive the same credit as outlined for multiline reinsurers providing traditional reinsurance. As before, no credit will be given for facilities from multiline reinsurers that do not possess a FER. Credit given for loss coverage facilities is dependent on the full amount of the facility being available to the ceding company. For example, if a facility was structured to cover the next $500 million in losses once $1 billion in losses had been incurred (the attachment point), it would be of less than full value if our capital adequacy model projected total losses of $1.3 billion. In this example, only $300 million of the facility would be drawn. Considering the false accuracy of projecting losses many years into the future with a high degree of precision, Standard & Poor's believes it is prudent to structure attachment points in this type of facility such that the entire amount of the facility would be available even if losses proved to be less than projected. Accordingly, the full amount of the facility will be considered for appropriate reinsurance credit only if the full amount of losses covered plus retained losses up to the attachment point are no more than 80% of total projected losses. Projected losses above the 80% level that are still eligible for coverage by the facility would be given credit at 50% of the otherwise applicable amount. No credit will be given for losses in excess of total projected losses that are eligible for coverage by a facility. Parent companies have a greater incentive to fund their capital commitments to the monoline insurer because they have a significant investment that would be at risk should the commitment not be funded. Arguably, this incentive is as strong as, if not stronger than, a monoline reinsurer's commitment to fund. Accordingly, credit for parent company capital commitments will be the same as is given monoline reinsurers. Committed Capital Facilities Summary Committed capital facilities will receive 100% credit provided that asset credit quality and market value risks have been eliminated to a 'AAA' certainty. Credit will be reduced to reflect existence of asset credit quality risk, market value risk, or counterparty risk. Committed capital will be counted against an insurer's overall soft capital limits and will be limited as a percent of an insurer's capital structure. Committed capital facilities bring together the capital markets and reinsurance markets by creating a funded pool of capital that is available to the "beneficiary" in the event of significant losses. These facilities eliminate the risk that a soft capital provider will be unable or unwilling to perform through the mechanism of establishing a pool of funds that is available as needed. By investing in extremely high quality assets and by limiting when draws can occur, these facilities can provide essentially unquestioned access to funds without credit quality or market value risk. The securities issued to support Ambac Assurance Corp. and MBIA Insurance Corp. (Dutch Harbor Finance Sub-Trusts I, II, III, and IV, and Anchorage Finance Sub-Trusts I, II, III, and IV for Ambac; and North Castle Custodial Trusts I, II, III, and IV for MBIA) present the least credit quality and market value risk because they invest in short-term commercial paper, and draws on the facilities are allowable only on dates when the CP matures. Other facilities are possible that may incorporate greater credit quality and/or market value risks or that may use a swap provider to offset these risks. In these cases, the greater risks will be factored into the credit given to the facility on a case-by-case basis. The risk of a failed or dysfunctional auction relating to auction-rate preferred stock issued to fund the assets in the pool is a concern that must be taken into account. Standard & Poor's concern is that in the event of a failed or dysfunctional auction, the beneficiary may feel compelled to take out the securities to eliminate the potential for disgruntled security holders. The most likely way to take out the securities is by paying them off with proceeds from another security offering. Such an offering could have the effect of adding debt to the capital structure, which could be detrimental to the entity's credit rating. Reflecting this risk, Standard & Poor's believes issuing auction-rate securities to fund a committed capital facility is most appropriate for those bond insurers that are not part of a larger group, where there are a greater number of potential sources of adverse news that could cause an auction to fail to properly function. Specifically, bond insurers owned by a large, diversified group or by a small pool of investors are limited to auction-rate funded facilities equal to 10% of their adjusted statutory capital. (see glossary) All publicly held monoline insurers can have auction-rate funded facilities equal to 20% of adjusted statutory capital. Although these committed capital facilities offer many advantages over other forms of soft capital, particularly with regard to the durability of the access to funds and absence of reliance on a third party to perform under a contract, they are not necessarily as permanent nor do they provide as much flexibility as paid-in capital. Accordingly, they should not be viewed as equity for purposes of measuring overall soft capital usage or financial leverage. Therefore, committed capital facilities will be included in overall soft capital limits, and fees paid by the insurer are treated as interest expense when analyzing the consolidated enterprise. Because there is a critical mass of committed capital securities that need to be issued for market efficiency purposes, it is possible that such securities could need to be issued in an amount greater than the current amount allowable under this criteria. Amounts issued in excess of the allowable limits will not be treated as either debt or equity at the holding company level and will not be included as capital in the capital model. Over time, the insurer will get more credit for the facility as allowable amounts expand, reflecting growth in the capital base and soft capital usage limits. Collateralized Trust Funds As A Means Of Enhancing Credit Given For Reinsurance Summary Collateral in a trust isolated from the reinsurer, available to the ceding company on demand, can enhance the credit given for reinsurance. Appropriate haircuts, based on Standard & Poor's structured finance market value criteria, will be taken to reflect market value risk. Posting collateral can serve as an alternative to a multiline reinsurer obtaining a FER. As non-U.S. based, less-than 'AAA' rated multiline reinsurers allocated capital to the financial guarantee reinsurance markets over the past few years, the primary bond insurers were interested in adding some of these companies to their list of active reinsurers as a means of diversifying their sources of reinsurance and to access types of coverage the monoline reinsurers were unable or unwilling to provide. At the same time, the primary insurers were not willing to completely sacrifice credit quality to gain diversity. One solution was to seek credit for the collateral that these foreign reinsurers were posting anyway under the various state laws governing relationships between primary U.S. insurers and non-U.S. reinsurers. If sufficient collateral was not posted to get the credit desired, additional collateral could be posted. Standard & Poor's will give 'AAA' credit against ceded capital charges for reinsurance backed by collateral so long as the following structure is in place and under the following constraints: This structure is available only to reinsurers rated in the 'BBB' category or higher. The collateral must be posted in a third-party trust account for the benefit of the ceding company. Legal opinions must support the fact that the trust is completely independent of the reinsurer, cannot be changed, impaired, or recaptured in the event of financial stress at the reinsurer, and that the ceding company at all times has unimpeded access to the funds in the event of a nonpayment by the reinsurer for any reason. Acceptable collateral is limited to cash, U.S. government securities, 'A-1+' rated CP, and 'AAAm' rated money market funds. Other collateral will be considered on a case-by-case basis. Collateral should be marked to market daily and at all times should be valued (adjusted value) using Standard & Poor's structured finance market value criteria. If the adjusted value falls below the amount required to achieve the desired level of 'AAA' credit, the reinsurer must post additional collateral not later than three days from the date the collateral fell below required levels. Shortfalls must be reported to Standard & Poor's and the ceding company immediately along with remedial steps to be taken. Standard & Poor's should receive a quarterly report listing all securities held in the trust account. The report should include the type of security, maturity, Standard & Poor's collateral factor, and the net adjusted value. The independent third-party trustee for the trust should prepare this report. To compensate for the fact that the book of business ceded to the reinsurer is not identical to the ceding company's book of business, raising the possibility that the ceded book of business may perform more or less favorably than the ceding company's book, the amount of credit given for the adjusted value of the collateral will be discounted by 20%. This discount is not applied when collateral is being posted to increase the credit being given for facilities where a specified dollar amount of losses is being covered in excess of a stated attachment point. The section "Bank Lines and LOCs, Capital Support from Third Parties, and Parental Support" includes criteria that already incorporate a similar concept in defining the credit this type of facility would receive. Also, the reinsurer's book of business must exhibit satisfactory sector and geographic diversity and single-risk management. The net value of the collateral (adjusted using market value criteria and discounted by 20%) will be deducted from the exposure to the reinsurer. Exposure is measured as ceded capital charges. If the net collateral fully covers the exposure to the reinsurer, the ceding company will get 100% credit for the reinsurance. To the extent that the net value of the collateral is less than the full amount of capital charges ceded to a reinsurer, the excess of capital charges over the net value of the collateral will be viewed as exposure to the reinsurer and credited at the appropriate rate. Credit for collateral is to be given independent of whether the reinsurer has a FER. In scenarios in which the net value of the collateral covers most if not all of the exposure to the reinsurer, the ceding company will receive substantial credit for the reinsurance. Implementation All criteria announced in this article are effective immediately. To the extent that a ceding company fails to meet any criteria or standards solely due to changes to these criteria, ample time will be allowed for the violations to be corrected. As a general rule, Standard & Poor's expects that problems should be resolved within a six-month period. Effect Of Changes From a practical standpoint, with the exception of the decision to give no credit to reinsurance from multiline reinsurers that do not possess a Standard & Poor's FER, most of the new criteria will have at most a small effect. Since the bulk of traditional reinsurance is provided to 'AAA' primary insurers by 'AAA' and 'AA' rated monoline reinsurers, the new criteria has no effect because there were no changes in criteria that affects these relationships. There were a few multiline reinsurers that were actively providing traditional reinsurance to the 'AAA' primaries. The effect on the ceding companies of not receiving any credit for this reinsurance is not insignificant but is manageable. Since these companies may already post some collateral as required by regulation, the ceding companies may be able to get some credit for the reinsurance. The decision to grant no credit to multiline reinsurers that do not have FERs seemingly flies in the face of the benefits of diversifying sources of reinsurance. Since there are few multiline reinsurers that will be able to offer significant reinsurance credit because they do not have FERs, the ceding companies will be challenged to diversify their sources of reinsurance. However, given the risks of reduced payment or non-payment from multiline insurers, which as a class has shown a significant likelihood to deny or negotiate downward significant financial guarantee claims, Standard & Poor's believes this risk far outweighs the benefits of diversity. Financial guarantee insurers are better served dealing with those players, albeit a small number, that are dedicated to the financial guarantee business and are willing and able to run it in a professional manner. Multiline reinsurers without FERs that seek to participate in this business going forward have the option of applying for a FER or posting collateral to receive credit for their reinsurance. These updated criteria codify the necessary structure and operating requirements for posting collateral. For the 'AA' and 'A' primary insurers, they will be receiving less credit than before for reinsurance from less-than 'AAA' rated reinsurers. There is a limited amount of this reinsurance outstanding. For the bank lines and LOCs that provide loss coverage, which currently amount to approximately $1.3 billion, the credit will be reduced by five percentage points from what was previously given. This is a small change and should not have a major effect on any company. The minimal effect is even lower than what would have been the case as recently as a year ago because the amount of these facilities outstanding has been reduced by $1.0 billion and replaced by committed capital facilities that receive 100% reinsurance credit. The recent innovation of committed capital facilities has made available a new class of capital substitute that offers superior benefits compared to existing products and hopefully will spur further development of additional variations on this theme. Glossary Adjusted statutory capital--The sum of statutory capital plus committed capital facilities. Attachment point--For insurance policies or bank facilities structured to cover a stated amount of losses once losses exceed a specified level, the attachment point identifies the point at which losses are no longer retained by the ceding company but instead are covered by the bank or reinsurer providing coverage. Coverage amounts are expressed in monetary terms. Book of business--The entire amount of insurance obligations currently outstanding under policies written to date. CDO Evaluator--A Standard & Poor's-developed, Monte Carlo-based risk management tool used to evaluate the credit quality of a portfolio, taking into consideration the credit rating, size, and maturity of each asset, and the correlation between each pair of assets. The credit quality of the portfolio is presented in terms of a probability distribution for potential default rates. Cede--To reinsure the liabilities associated with insurance policies by passing a portion of the risk exposure and the related premium to a reinsurer. Ceding company--An insurer that has assumed risk that it seeks to reinsure. In any reinsurance transaction, there is a ceding company and a reinsurer. Committed capital facility--A funded pool of capital available to the "beneficiary" at the beneficiary's option. In the event the beneficiary needs to supplement its capital position, the facility would liquefy its assets and purchase securities issued by the beneficiary. This structure is superior to soft capital because it can provide unquestioned access to funds without concerns regarding the willingness of a soft capital provider to perform, but it is not as favorable as paid-in capital since the funds are not "in the bank." Monoline insurer--An insurer that writes only financial guarantee insurance. Multiline insurer--An insurer that writes many types of property and casualty insurance. Primary insurer--An insurer that directly assumes liabilities by issuing an insurance policy to the insured. Reinsurance--An arrangement under which an insurer passes risk and obligations to another insurer. Reinsurance serves several purposes, including reducing risk, diversifying exposure, and providing financial flexibility. Reinsurer--An insurance company that assumes risk initially assumed by another insurer. Soft capital--A term for reinsurance arrangements and other capital substitutes, such as irrevocable, multiyear bank lines or LOCs and owners' commitments to supply additional capital. The common characteristics are that they are not "money in the bank" but commitments to provide resources in the future, and that they rely on the willingness and ability of a third party to perform its contractual obligation. For purposes of this article, the term "soft capital" will include committed capital facilities. Statutory capital--The sum of an insurance company's capital and surplus plus contingency reserves reported under statutory accounting principles.