Article Title: ARCHIVE | Criteria | Insurance | Bond: Bond Insurer Holding Company Criteria Data: (EDITOR'S NOTE: —This criteria article is no longer current. It has been superseded by the article titled "Criteria | Insurance | General: Holding Company Analysis," published June 11, 2009.) Much of the criteria used to evaluate bond insurance holding companies are similar to those used to evaluate other financial institutions. However, given the unique regulatory and operating environment that insurers operate within, along with the unparalleled credit and rating sensitivity of the bond insurers in terms of the viability of their franchise, there are some key differences. Standard & Poor's Ratings Services evaluates the parent companies of bond insurance organizations relative to the operating insurance company subsidiaries they own. In the simplest cases, the holding company evaluation is directly related to the creditworthiness of the subsidiary. This approach is used if the holding company is a true holding company (if the holding company has no operating characteristics in its own right). It is also used if the structure is direct (no intermediate holding companies) and if there is essentially one subsidiary. This is generally true for most bond insurance operations. While there can be multiple subsidiaries, for analytical purposes they are usually linked and treated as one unit. For monoline bond insurance companies, however, because of protective state insurance regulations the interests of holding company creditors are clearly subordinate to those of operating company policyholders. Unlike industrial corporations, where stronger operating companies can be drawn into the bankruptcy of a weaker parent, state-regulated insurance companies are not subject to U.S. bankruptcy codes. Further, state regulations impose explicit and implicit dividend and asset-transfer restrictions on the regulated subsidiaries. Although such restrictions can exist in debt covenant form for industrial corporations, the likelihood of stricter and more-timely enforcement is greater in the insurance industry. Therefore, as a general rule for all insurance companies, a gap will exist between debt and financial strength ratings to reflect the subordinate status of holding company creditors in relation to operating company policyholders. The predominant insurance operating company/holding company rating gap is one full rating category (three notches). A gap of this size recognizes the dependence on a dividend stream from subsidiaries for debt, servicing of preferred stock, or both. It also recognizes that regulatory intervention can restrict the flow of funds. Exceptions resulting in wider rating distinctions can involve those cases where the bond insurance holding company is positioned as an intermediate holding company in an organizational structure or where a significant amount of higher risk non-bond insurance operations exist. For companies based outside the U.S., the regulatory framework might not provide the same protections afforded U.S.-based companies in terms of restrictions on dividends and asset transfers or bankruptcy protection. The absence of these restrictions could become significant in circumstances where the holding company is either highly leveraged or has significant other operations. Board of director resolutions can compensate for some of these missing protections. The rating methodology of bond insurance holding companies employs an analytical framework that divides the overall analysis into six categories, highlighted below. Although each category reflects appropriately weighted assessments of both bond insurance and non-bond insurance operations, and is separately graded, the ultimate debt rating conclusion is a function of the interdependence of all of the analytical elements and a rating committee's determination of the relative significance of the various categories. Industry Risk In general, the lower the industry risk the higher the potential rating on companies in that sector or line of business. Key points Standard & Poor's considers in its analysis of industry risk are: The threat of substitute products or services; The sector's competitiveness and volatility, as well as the risk of large losses; The bargaining power of insurance buyers; The strength of the regulatory, legal, and accounting framework in which the insurer operates; and Barriers to entry and exit. As an example, industry risk is the principal reason why a start-up bond insurer operating in "emerging market" countries could likely obtain no better than an 'A' rating, assuming Standard & Poor's was comfortable assigning a rating at all. The incremental risk of increased volatility and greater potential for large losses is greater for such a sector of operation. Likewise, regulatory, legal, and accounting systems are less developed for such a sector of operation. Industry risk was also linked to the lowering of ratings for several monoline reinsurers several years ago. Increased bargaining power of reinsurance buyers led to a diminishment in the quality and profitability of business being written. Because of higher industry risk, a monoline reinsurer's maximum rating is capped at 'AA', barring unusual circumstances. Major Analytical Factors INDUSTRY RISK Regulatory environment Economic sensitivity Barriers to entry/exit

Market opportunities/impediments MANAGEMENT/CORPORATE STRATEGY Track record Credibility Risk tolerance Managerial vision BUSINESS PLAN Demand for products/services Market share Insurance portfolio characteristics Sector and geographic mix Underlying credit quality Capital charge profile(s) Margin of safety trends Operating company support FINANCIAL PERFORMANCE Return on equity Operating return on equity Loss/expense ratios LIQUIDITY/FINANCIAL FLEXIBILITY Sources of liquidity Internal (cash flow, asset liquidation) External (reinsurance, equity/debt) Debt amortization schedule CAPITALIZATION Debt leverage Debt + preferred leverage Double leverage GAAP interest coverage Statutory interest coverage Management And Corporate Strategy Although management has little control over industry risk, altering the company's competitive position to its advantage and managing its resources and finances in a prudent and ultimately profitable way are internal factors over which management can exert significant influence. Standard & Poor's considers management and corporate strategy the key element of the criteria that form the foundation of the financial strength rating process. An organization's strategy, operational effectiveness, and financial risk tolerance will shape its competitiveness in the marketplace and the strength of its financial profile. Questions such as how strategic milestones are developed and updated and how compensation systems are designed to support them are relevant. Standard & Poor's task is to evaluate whether the strategy management has chosen is consistent with the organization's capabilities and whether it makes sense in its marketplace. Standard & Poor's also wants to know management's record of converting plans into action, and if effective systems are in place to communicate plans to lower management and assess performance versus plans. Operational effectiveness essentially involves assessing a company's ability to execute the chosen strategy. Standard & Poor's evaluates management's expertise in operating each line of business as well as assessing the adequacy of audit and control systems. How have they performed compared with expectations? What type of internal audit controls does the company use? Is the company centralized or decentralized, and does this structure improve efficiencies? Does the company's organization fit with the strategy chosen? Evaluating financial risk tolerance enables Standard & Poor's to understand management's views on financial goals, capital structure, financial and accounting conservatism, board oversight, and risk acceptance. What are management's specific financial goals? What are the amount and types of capital in the capital structure and the level of leverage employed? What are the quality and allocation of invested assets and capital adequacy targets? What are the reserving practices and the use of reinsurance? How strong is the risk-management function? Are these guidelines detailed or general? Do they apply to many areas of the operation or just a few? Does the company generally operate aggressively or conservatively? Is the board of directors involved in the management of the company, or is it just a "rubber stamp"? Is the company run for management, the owners, or the policyholders? Responses to these questions reveal management's conservative or aggressive posture in managing the balance sheet, and form the basis of Standard & Poor's opinion. Most importantly, organizational structure and management breadth and experience must support the strategy to produce the desired results. Who are the senior managers? What are their functional backgrounds? How long has the team been together? Business Review This analytical category comprises two areas: a company's competitive position and the overall quality of both the business being written and the insured book of business. In assessing future financial strength, it is critical to identify an insurer's fundamental characteristics and its source of competitive advantage or disadvantage. Competitive position can prove to be one of the decisive factors underlying a final rating decision, as the analyst defines the key characteristics of organizational structure and activity that constitute competitive strengths and weaknesses. These strengths and weaknesses are intricately tied to the insurer's strategy and operational effectiveness and will strongly influence its financial profile. It is through Standard & Poor's review of a company's competitive position in each major line and region of activity that it is determined whether there is solid potential for satisfactory performance. However, while a strong business position and revenue growth are generally positive factors, a strategy of growth for growth's sake can be a road to ruin, and is especially inappropriate in soft markets where excess growth can be obtained only by underpricing business. Over an intermediate to long-term horizon, Standard & Poor's would expect strong companies to have good growth prospects. This view is always balanced against a belief that there are times when no growth or slow growth is better to preserve earnings and capital. In making the evaluation, a clear link exists between the strength of an insurer's competitive position and its corporate strategy. On the other hand, an insurer's competitive position must be evaluated in the context of the financial performance expected of the company. Standard & Poor's expects strong companies to maintain sound levels of capital and earnings. To determine if there has been a trade-off between business growth and underwriting quality, Standard & Poor's examines annual book of business trends for sector weighted average capital charges; sector weighted average premium rates; and, in combination as a ratio of weighted average premium rate to weighted average capital charge, a measure known as the risk-adjusted pricing index. Sector concentrations and trends in credit estimates for transactions in the overall portfolio are also examined in the business review process. Financial Performance The assessment of a company's earnings performance is an integral part of the overall rating analysis. The measurement of earnings focuses on a company's ability to efficiently translate its strategies and competitive strengths into growth opportunities and sustainable margins on its revenues. Although a bond insurer's level of capital adequacy provides an equity cushion relative to the risks it takes, a company's prospective earnings performance will determine its ability to grow and attract capital. Standard & Poor's bases its analysis of operating performance principally on ROE, using both reported net income and operating income. Operating income typically excludes gains and losses associated with FASB 133 CDS mark to market adjustments. Although ROE can be affected by holding company debt leverage, most of the industry employs a similar debt leverage strategy, and adjustments are made for exceptions. Standard & Poor's also evaluates earnings before tax and capital gains to understand the profitability of the recurring sources of income without the effects of these two variables. Standard & Poor's believes that for many companies, capital gains are largely opportunistic and are a function of economic and interest rate conditions. However, to the extent that a company can demonstrate a consistent strategy of reaping capital gains as a part of a total investment and operating strategy, Standard & Poor's will adjust its analysis accordingly. Capitalization In conducting its analysis of an insurer's capital structure, including hybrid equity, Standard & Poor's first attempts to understand management's goals regarding the various forms of capital present in a group's structure. For example: Is the capital permanent, or will it eventually be replaced? The more funds are perceived as permanent and not putting an unnecessary strain on the group regarding servicing requirements, the more favorably they are viewed. The two primary leverage ratios that are used to evaluate insurance holding companies are "debt leverage": debt/total capital; and "debt + preferred leverage": debt + preferred, including hybrids)/total capital. Debt includes both long- and short-term debt; total capital includes all debt, all preferred stock, all hybrid capital, and common stock. These ratios are calculated on a consolidated company basis, and capitalized leases should be included in debt. When analyzing consolidated company leverage, hybrid equity raised at the operating company could be treated as equity depending on structure and level of entitled issuance (see "Hybrid Securities Can Have Varying Effects On Bond Insurer Capital," July 27, 2006, RatingsDirect). Double leverage arises when the holding company issues debt and downstreams it as equity to insurance operating subsidiaries, where it receives full credit as capital available to support insurance operations under both Standard & Poor's and regulatory risk-based models. An issue arises if servicing or repayment of all, or a portion, of the holding company debt is dependent on a continuing flow of funds from the insurance operating subsidiaries. In that circumstance, the holding company debt becomes, in effect, a call on the capital of the operating insurance subsidiaries and brings into question the permanence of such equity. The double-leverage ratio is computed as the ratio of nonconsolidated investment in subsidiaries to nonconsolidated common equity plus hybrid equity. There are several income statement and cash flow-based ratios that are used to evaluate an insurance holding company's debt-servicing capabilities. The primary measure is GAAP-based, where GAAP interest coverage equals: (GAAP pretax operating income + interest expense)/interest expense; interest expense is adjusted to include the amortization of interest in any sale/leaseback of property or equipment or any other type of lease. When evaluating a preferred stock rating, Standard & Poor's uses GAAP fixed-charge coverage instead of interest coverage, where GAAP fixed-charge coverage equals: (GAAP pretax operating income + interest expense)/(interest expense + tax-adjusted preferred stock dividends); interest expense is adjusted to include the amortization of interest in any sale/leaseback of property or equipment or any other type of lease. Both of these coverage ratios are calculated on a consolidated company basis. Statutory interest coverage measures the various sources of cash available for upstreaming to the holding company as well as the net cash being generated at the holding company, and compares these sources with interest expense. Statutory interest coverage equals: (dividend capacity + continuing holding company income - continuing holding company operating expenses excluding interest expense)/interest expense. Interest expense is based on consolidated company statements. Liquidity And Financial Flexibility The primary source of liquidity for a bond insurer is derived from operating cash flows. A second source of liquidity is the bond insurer's investment portfolio. Finally, it is relevant to take into consideration other outside sources of liquidity, such as bank lines of credit and established CP programs. Financial flexibility relates to a bond insurer's ability to raise capital or otherwise raise cash. Typically, these sources consist of demonstrated access to multiple segments of the capital markets, such as the long-term public debt market and the CP market. In addition, a company might hold assets with significant unrealized capital gains that could be sold without affecting the basic enterprise. The ability or demonstrated willingness to raise common equity capital is another important source of financial flexibility, as is the ability to obtain reinsurance in adequate amounts from a variety of high-quality markets. Although prudent use of reinsurance is often advisable, it can be misused or overused. Standard & Poor's looks for reinsurance and other third-party capital usage to generally not exceed 33% of claims paid in the capital adequacy modeling exercise. A reinsurer's ability and willingness to pay is also addressed by bond insurance criteria. By far, the best source of long-term flexibility is created through generating good returns. Therefore, the returns on equity, assets, and permanent capital are evidence of the company's long-term access to sources of financing. Regulatory Disclosures For Each Credit Rating Including Ratings List Table Disclosures include requirements relating to press releases or reports published in accordance with Article 10(1), 10(2), and 10(5), and Annex I, Section D, I, 1, 2, 2a, 4, and 5. These requirements are available by rating via the link titled "Regulatory Disclosure" and include, but are not limited to: Key Elements Underlying The Credit Rating ESG Credit Factors Solicited Or Unsolicited Status Analysts Primarily Responsible For The Credit Rating Office Responsible For The Credit Rating Materials Used In The Credit Rating Process Criteria Applied Models Applied, Loss, And Cash Flow Analysis Performed Scenario Analysis Sensitivity Analysis Risk Warning, Understanding Credit Rating Categorizations, And Criteria Rated Entity Notification Ancillary And Additional Services Attributes And Limitations Of The Credit Rating Information Specific To Structured Finance And Securitization Instruments