MOODY'S
INVESTORS SERVICE

CROSS-SECTOR RATING METHODOLOGY

Evaluating Operating Debt Used by Insurance Companies

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This rating methodology replaces "Evaluating Operating Debt Used by Insurance Companies" last revised on May 19, 2011. We have updated some outdated links.

Summary

This report defines the characteristics of operating debt in the insurance sector and outlines the criteria Moody's uses to differentiate between operating and financial debt in our global insurance rating methodologies. It also looks at how the treatment of operating debt can affect an insurance company's financial flexibility and ratings.

Operating Debt Criteria Summary

We consider the following to be characteristic of operating debt:

» The debt and associated assets form a "closed system" that is notionally segregated from a company's other activities and in which cash flows and duration are well matched.

» Assets are of high quality, with stable cash flows and minimal market volatility, unless the asset maturities are well-matched to the related debt, and are of sufficient size to ensure that debt service and repayment is highly likely.

Financial Leverage and Operating Leverage

As part of our global insurance rating methodologies we analyze the financial flexibility of insurers, examining both total leverage and financial leverage. A key difference between these two measures is that total leverage includes, in the numerator, debt we classify as "operating debt."

Financial leverage refers to the amount of capital that is financed through borrowed money. In general, higher-rated insurance companies tend to have lower levels of financial leverage. In addition, higher-rated issuers tend to have larger cushions in their earnings capacity and dividend capacity relative to their interest and preferred dividend expense compared to lower rated peers.

Operating debt, on the other hand, is not considered part of a company's capital structure; it is expected to be self-supporting (with its own dedicated assets) and self-liquidating (with assets and liabilities reasonably matched), and repayments should not depend on the enterprise's other resources. Because operating debt does not leverage a company's capital base, earnings, or cash flow, we believe it imposes a lower burden on an enterprise than financial debt.

Nonetheless, debt that meets the criteria of operating debt still represents incremental risk for an insurer, since too much operating debt can constrain financial flexibility. Accordingly, in calculating the financial leverage metric for our rating scorecards, the allowance for operating debt is capped at 10 percentage points.

Operating Debt and Ratings

Although the status of most transactions that currently receive operating debt treatment is unlikely to change, it is possible that, in applying these guidelines, some operating debt may be reclassified as financial debt, resulting in increased financial leverage for a given issuer. Nevertheless, we do not expect rating changes as a consequence of this refinement because our analysis of financial flexibility already reflects the risks of such transactions.

Our rating methodology allows for analyst judgment in assessing a particular issuer's financial flexibility. If debt does not meet the operating debt criteria outlined in this report, it may still exert considerably less stress on an enterprise's capital than we typically ascribe to financial debt, and if so, this will influence our analysis of financial flexibility, a key factor in determining an issuer's rating.

Criteria for Determining Operating Debt

The criteria discussed in this section are used to determine whether a transaction is considered operating or financial debt for the purpose of calculating financial flexibility metrics and apply regardless of what legal entity issues the debt. The materiality of deviations from these guidelines are factored into a final decision on the treatment of operating debt. Although we would not expect the determination of specific debt as operating debt to change over time, a transaction's conformity to these criteria could change due to modifications in investment guidelines or other circumstance. As a result, we periodically review an activity's operating debt status to confirm that it still meets our criteria.

ALM and Refinancing Issues

Operating debt is intended to be self-liquidating; that is, assets are expected to be well matched to the debt and thus should run off/mature as the debt matures. Asset and liability duration mismatch should be limited to +/- 6 months. Assets and liabilities must become more closely cash matched as the time to maturity (or to earliest put date) of a debt shortens (i.e., less than 6 months). Conformity with this criteria essentially defines the self-liquidating nature of the assets and liabilities. For example, short-term financing would provide a good match for credit card receivables, but would not meet the asset-liability management (ALM) matching test if it financed warehousing of commercial mortgage loans for securitization.

For operating debt treatment, refinance risk has to be minimal and pricing step-up risk must be small (i.e., less than 100 basis points). This criterion applies to operating debt transactions, including spread lending business at holding companies or non-regulated subsidiaries. However, because assets can be easily transferred among various investment segments of the general account investment portfolio, a less stringent standard applies to general account spread lending at regulated operating companies.

Debt related to transactions funding the excess of regulatory reserves over economic reserves (e.g., XXX/AXXX deals in the U.S.) incorporate the expectation that the assets placed in the trust will be well matched to the term of the corresponding debt in order to receive operating debt treatment. Independently, the need to finance regulatory reserves may exceed the term of the debt and a longer-term financing solution may be required upon maturity of the debt. Where the debt (whether deemed operating or financial debt) funding the trust assets matures within three years, we will consider the impact on capital adequacy and financial flexibility of a stress scenario bringing the reserves back on to the ceding company's balance sheet in rating the sponsor.

Asset Quality

Asset risk must be low. Operating debt is expected to be backed by high-quality assets with minimal exposure to market volatility except as noted previously (e.g., excludes equity securities). Our evaluation of asset quality is based on investment guidelines for the transaction, which are periodically monitored for compliance.

The characteristics of high-quality assets include the following:[1]

» Investment grade assets that have an average rating of A3 or higher, based on WARF.[2]

» Well diversified, with no single security (other than Aaa rated government securities) representing more than 1% of transaction assets and the largest 10 securities (excluding Aaa government securities) representing no more than 5% of total transaction assets. In addition, a portfolio will have no material concentrations in any sector.

» High-quality assets are liquid – 144a or publicly-traded bonds - any illiquid securities tightly matched to the term of the debt.

Segregation of Assets and Liabilities

The debt, assets, and related capital, if applicable, must be segregated from the other activities and assets of an enterprise. For transactions (e.g., XXX/AXXX or value of the in-force (VIF)[3]) with special purpose vehicles, assets must be legally segregated. However, portfolios of transactions, such as securities lending or other spread-based investing business conducted in an operating company, may not require legal segregation, but still must be tracked as separate portfolios.

Stable Cash Flows

The cash flows from the assets are expected to be generally stable and predictable. Transactions that are subject to complex modeling/complex risks (i.e., most insurance protection and annuity liabilities) must have a substantial capital cushion based on assumptions that the sponsor can demonstrate are conservative.

Forms a "Closed System"

The assets and liabilities are expected to form a "closed system," or one for which support from the rest of the enterprise is neither expected nor needed. The transaction itself should cover essentially all interest and principal payments. If a material deficiency is likely under a stress scenario, more capital must be allocated upfront.

Capital Allocation

An operating debt transaction should not leverage an enterprise's overall capital; that is, adequate capital should be included with the segregated assets and liabilities to absorb unexpected losses or to generate cash to cover interest payments if timing differences occur. The possibility of losses materializing from operating

1 Overall basket limit of 5% of securities not meeting high-asset quality characteristics.

2 For information regarding Weighted Average Rating Factor (WARF), see "Moody's Approach to Rating Collateralized Loan Obligations" which may be accessed among Structured Finance methodologies using the link in the Related Research section of this report.

3 In a value of the in-force (VIF) transaction, a life insurance company monetizes the future profits expected to emerge from a pre-defined book of business, by issuing debt, which is repaid as profits emerge from this securitized book.

debt should be extremely remote (e.g., a 50 basis point probability over 10 years). Capital is viewed broadly, on an economic rather than on an accounting basis. In this context, capital allocated for operating debt transactions could be hard capital backed by cash/assets, or capital resulting from over-collateralization of assets versus liabilities, particularly when taking into account the present value of future cash flows. Capital in the form of over-collateralized assets applies in general to VIF deals, which typically lack significant amounts of hard capital but include capital on an economic basis.

Rather than our becoming deeply involved in testing the inner workings of actuarial analysis and complex models that may rely on a large variety of assumptions, issuers will be asked to demonstrate that their transactions conform to our guidelines, even in stress scenarios, and that their underlying assumptions are appropriately conservative, as discussed above.

Determining the amount of required capital is always a probabilistic estimate. If assumption changes during the life of a transaction lead to moderate additional capital requirements (i.e., less than 10% of the original capital) and the assumptions are believed to be conservatively estimable, this should not negate the original operating leverage treatment. However, a more significant under-estimation of required capital would suggest that the drivers of the transaction are not well understood, and would lead to a reclassification of the transaction to financial debt.

Recourse Transactions Only

Non-recourse debt is excluded from both total and financial leverage because it is not considered an economic lien on an enterprise. However, business considerations, reputation, market consequences and other factors that may incent an issuer to support a transaction for which it has no legal responsibility will influence whether we would consider it recourse or non-recourse. If we consider debt to be recourse to the issuer, we will analyze it to determine whether it is operating or financial debt, even if it is legally non-recourse.

Timing of Operating Debt Issuance

Only transactions that are funded with specific debt issuances may be classified as operating debt. Identifying a particular debt issue facilitates assessing the ALM characteristics by isolating the term of the debt. Debt must be issued as closely as possible to (and within six months of) the acquisition of associated assets in order to be treated as operating debt.

Policyholder Obligations Generally Not Classified as Debt

An example of a policyholder obligation that is typically not considered debt is a funding agreement that is expected to be invested in a matched book of assets. However, under certain circumstances, these transactions could be considered financial debt: for example, if there were a significant ALM mismatch, or if proceeds were used for other purposes, such as purchasing blocks of business. In addition, if the liability appears on the company's consolidated balance sheet as debt (e.g. funding agreement backed notes for some companies), then it will be included in our leverage calculations and evaluated as either operating or financial debt.

Securities Lending/Repos

Holding company securities lending/repo transactions will be captured in total leverage and will be analyzed to determine whether they should be accorded operating debt treatment, per the criteria outlined above. However, since assets can be moved freely among different investment portfolios, securities lending and repo transactions at an operating company normally are not considered either operating or financial debt analytically, although if they appear on the consolidated balance sheet as debt, then the amounts will be included in our leverage calculations. Similar to funding agreements, if their characteristics deviate significantly from our operating debt criteria, they could be classified as financial debt.

Collateral Posting

Transactions subject to collateral posting may not be eligible for operating debt treatment. The absence of a cap for any required collateral posting would disqualify the entire amount from consideration. If there is a cap on the collateral posting, such amount will be treated as financial leverage, and the difference between the amount of debt and the cap will be evaluated for operating debt treatment. For example, collateral posting or off-schedule debt repayment required by increases in a company's credit default swap (CDS) spread introduces liquidity risk that is not contemplated in operating debt transactions. In 2008 and 2009, companies with CDS trigger provisions were required to post collateral as their spreads widened. In addition, liquidity needs arising from such transactions will be incorporated into a company's overall liquidity analysis per the relevant rating methodology.

Letters of Credit

Our rating methodology treats uncollateralized letters of credit (LOCs) that provide funding for regulatory or working capital as financial debt and includes them in financial leverage. However, we exclude LOCs associated with remote risks from our analysis of leverage (both financial and operating), including those used in connection with U.S. XXX/AXXX transactions; we analyze these by assessing their impact on liquidity and capital adequacy, and not on leverage and coverage.

Off-Balance Sheet Debt Is Analyzed

Although off-balance sheet debt is not included in the calculations of either the total leverage or financial leverage ratio, any material off-balance sheet debt is evaluated as part of our analysis. If the impact is material, it can affect the financial flexibility component of the credit profile through the analyst overlay.

Incorporating Operating Debt into Global Insurance Methodology Financial Flexibility Measures

Total Leverage Ratio

All debt, both financial and operating, is included in this ratio.

Financial Leverage Ratio

Operating debt is excluded from debt, with the exclusion capped at 10 percentage points of the total leverage ratio. Equity associated with supporting the operating debt is deducted from equity in calculating the financial leverage ratio.

Coverage Ratios

Interest associated with enterprise-wide operating debt is excluded from the denominator (interest expense) of the earnings coverage ratio. Interest associated with holding company-only operating debt is excluded from the denominator (interest expense) of the cash flow coverage ratio. For the earnings coverage ratio, interest associated with operating debt is also deducted from the numerator (EBIT) as a proxy for earnings derived from the businesses associated with the operating debt.

Moody's Related Research

The methodology detailed in this report is used in connection with the rating of insurance companies in diverse lines. Rating and cross-sector methodologies, including those applied to US health insurers, life insurers, property and casualty insurers, US title insurance companies, reinsurers, mortgage insurers, financial guaranty insurance companies, and credit insurance companies, may be found here.

For definitions of Moody's most common ratio terms, please see Moody's Basic Definitions for Credit Statistics (User's Guide), June 2011.

Please refer to Moody's Rating Symbols & Definitions, which is available here, for further information.

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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