BEST'S METHODOLOGY AND CRITERIA

Securitization of Period-Certain and Life-Contingent Structured Settlements

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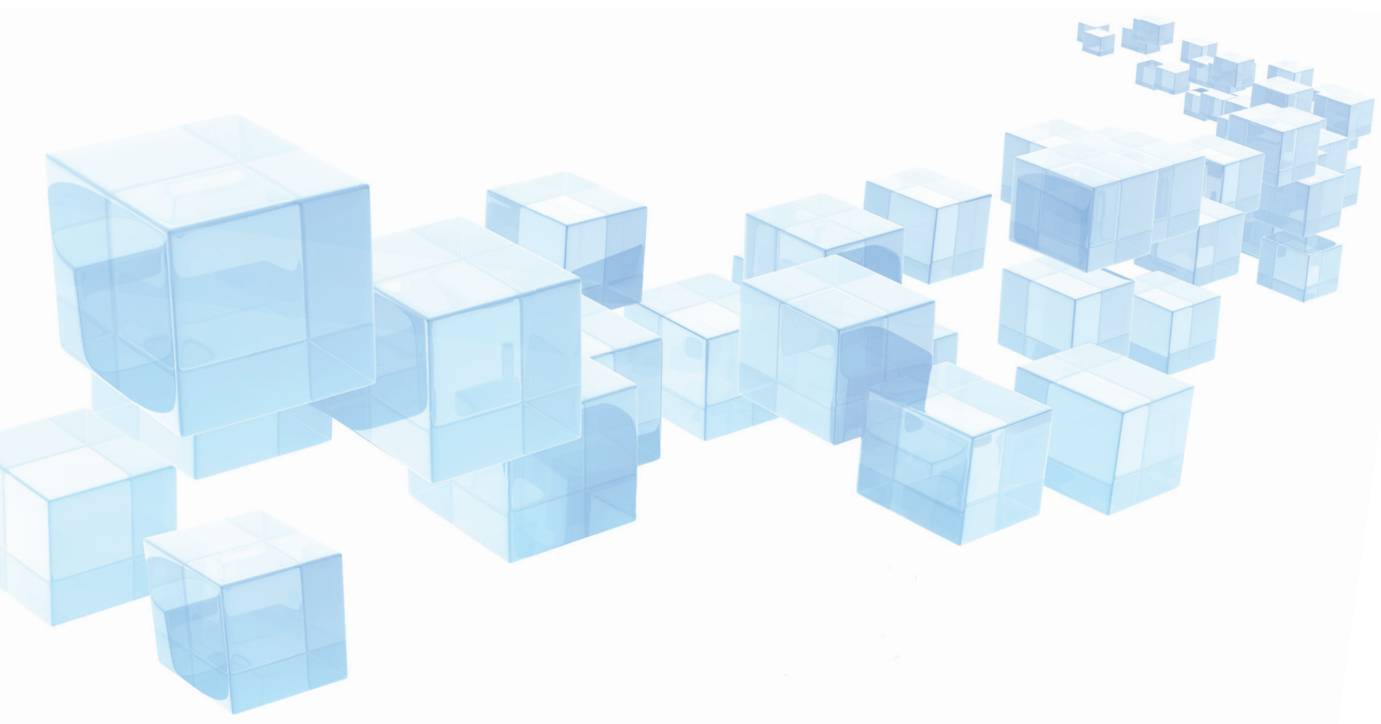

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Outline

The following criteria procedure should be read in conjunction with *Best's Insurance-Linked Securities & Structures Methodology* (BILSM) and all other related BILSM criteria procedures. The BILSM provides a comprehensive explanation of A.M. Best Rating Services' rating process for insurance-linked securities and insurance-linked structures.

A. Market Overview

A structured settlement is an agreement between a claimant and a defendant whereby the claimant agrees to settle a lawsuit in exchange for periodic payments to be made by the defendant to the claimant over time. Structured settlements are a popular method for settling personal injury, product liability, medical malpractice and wrongful death cases. The defendant discharges its obligation by purchasing an annuity from a highly rated life insurance company.

In general, there are two varieties of annuities utilized in structured settlements: a) period-certain annuities that generate guaranteed, periodic payments for a defined term to the annuitants and can be fixed or can escalate based on a specified compounding rate and/or inflation rate; and b) life-contingent annuities in which specified payments are made to annuitants until they die. There are also annuities that combine period-certain and life-contingent features.

Structured settlements have been securitized into asset-backed securities transactions for more than 10 years. Since 2001, such transactions have been largely facilitated by the enactment of settlement transfer laws that require court orders before structured settlement cash flows can be purchased. Court-ordered transfers have virtually eliminated diversion risk – the risk that claimants in structured settlements who have sold their annuity cash flows to purchasers would divert such cash flows back to their own accounts in violation of their sales agreements.

This criteria procedure summarizes how A.M. Best will assess structured settlement securitizations involving period-certain and/or life-contingent annuities.

Historical Tax Issues Associated With Structured Settlements

Structured settlements – which often involve periodic payments over a long term – evolved as a way to prevent claimants from improvidently exhausting their awards.

The federal tax characterization of an award matters both to the claimant and to the defendant. Although lump-sum case-settlement payments have always been excluded from the claimant's income – as specified in Section 104 of the Internal Revenue Code (IRC) – the tax treatment of a structured settlement award once was uncertain. A claimant's annuity payments received from a structured settlement, for example, might formerly have been included in the claimant's income, even though clearly part of a tort settlement. In the late 1970s, the Internal Revenue Service (IRS) issued several rulings suggesting that tort settlement periodic payments would be excluded from the claimant's income as long as the claimant could not control or accelerate the payments. In 1982, an amendment to Section 104 of the IRC and enactment of Section 130 of the IRC clarified the tax treatment of structured settlements and revealed their potential advantages.

Section 130 allows defendants to fund their obligations via annuities and allows claimants to exclude such payments from their income, as long as (among other things) the payments are "fixed and determinable as to amount and time of payment" and "cannot be accelerated, deferred, increased, or decreased by the recipient." In response to claimants' desire to monetize such periodic payment rights, a market developed in which companies purchase a claimant's rights to future payments in exchange for a lump sum. This business of monetizing anticipated payments is known as "factoring," and the firms engaged in it as "factoring companies." The possibility of the factored structured settlements payments being deemed "accelerated," no longer being deemed "fixed and determinable," and accordingly, being denied the favorable tax treatment otherwise accorded tort settlement proceeds was a potential challenge. Factoring, it was feared, might disqualify payments from being excluded either from the payee's taxable income under Section 130 of the IRC or from the factoring company's income. But new legislation, prescribing a method to accomplish a factoring transaction while retaining favorable tax treatment, essentially eliminated this possibility.

The Victims of Terrorism Tax Relief Act of 2001 added Section 5891 to the IRC to govern the tax treatment of structured settlement factoring transactions. It imposes a stiff excise tax on anyone acquiring structured settlement payment rights in a factoring transaction, but makes exceptions for any factoring transaction "approved in advance in a qualified order." Approval essentially depends on a finding that the transaction is in the best interest of the claimant and is not contrary to law or court order. A "qualified order" may be issued "under the authority of an applicable State statute by an applicable State court."

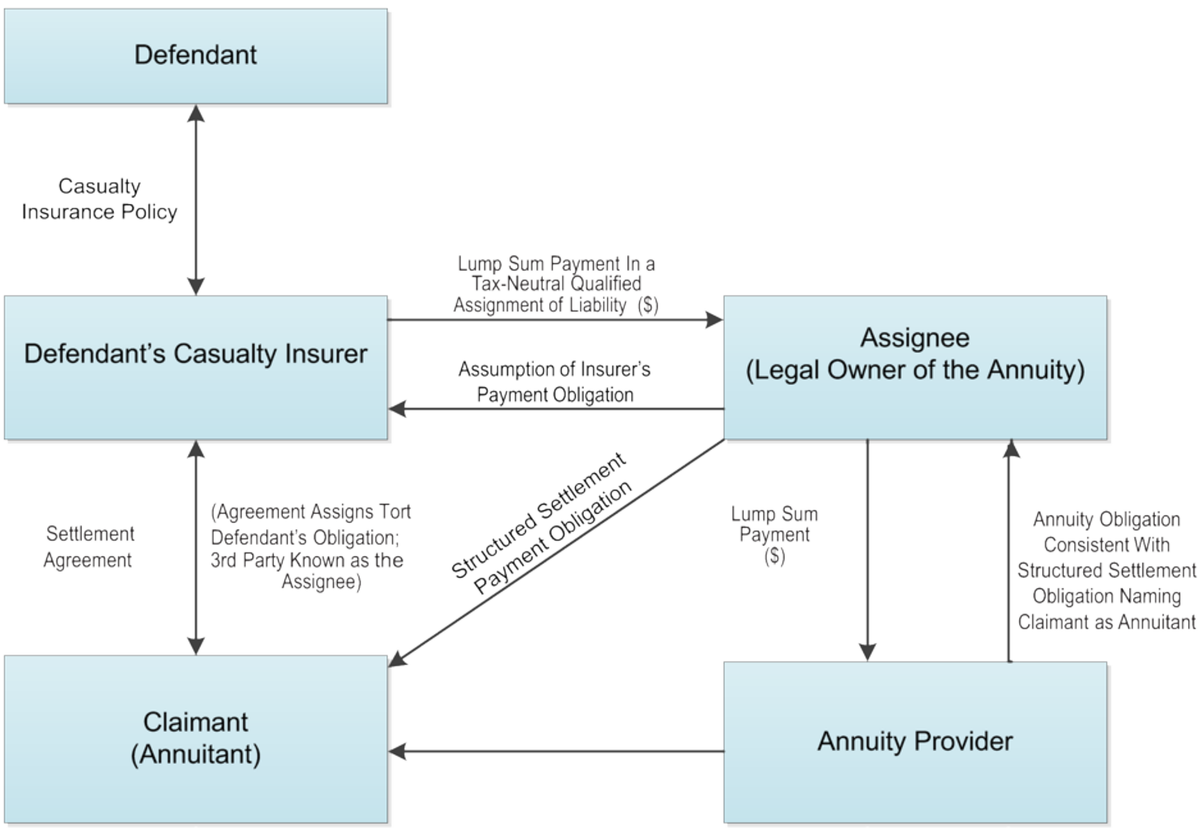
To support this scheme, states have passed statutes regulating the transfer of structured settlement payments and empowering their courts to conduct transfer proceedings and issue orders that comply with federal tax law. The goals of the transfer statutes are to:

- Provide tort obligors and annuity providers certainty regarding to whom the scheduled payments are to be made
- Ensure that tort claimants are treated fairly in their efforts to sell their scheduled payments
- Ensure that all interested parties receive prior notification of such assignments

Parties to a Structured Settlement

A structured settlement occurs once a structured-settlement agreement has been reached between parties, such as a claimant and a defendant. The agreement outlines the terms and compensation to be provided by the defendant or the defendant's casualty insurer. The defendant or defendant's casualty insurer – the party initially responsible for providing future compensation to the claimant – often will accomplish the defeasance of its obligation by purchasing an annuity contract from a third-party, typically a life/annuity insurance company. The transfer of its obligation often is accomplished by a qualified assignment either directly or indirectly (through another third party) to the annuity provider. The purchase of the annuity contract traditionally is accomplished through a single premium payment. At this point, neither the defendant nor its casualty insurer has any further obligation to make periodic payments to the claimant. The obligor becomes the annuity company, which then makes periodic payments to the claimant that match the periodic payments set forth in the structured settlement agreement. A simplified structured settlement transaction between a claimant and defendant is shown in **Exhibit A.1**. The transfer of obligations from the defendant to the assignee does not need to be a qualified assignment and the assignment companies need not be subsidiaries of the annuity providers.

Exhibit A.1: Basic Structured Settlement Transactions (Before Factoring)



The Role of Factoring Companies

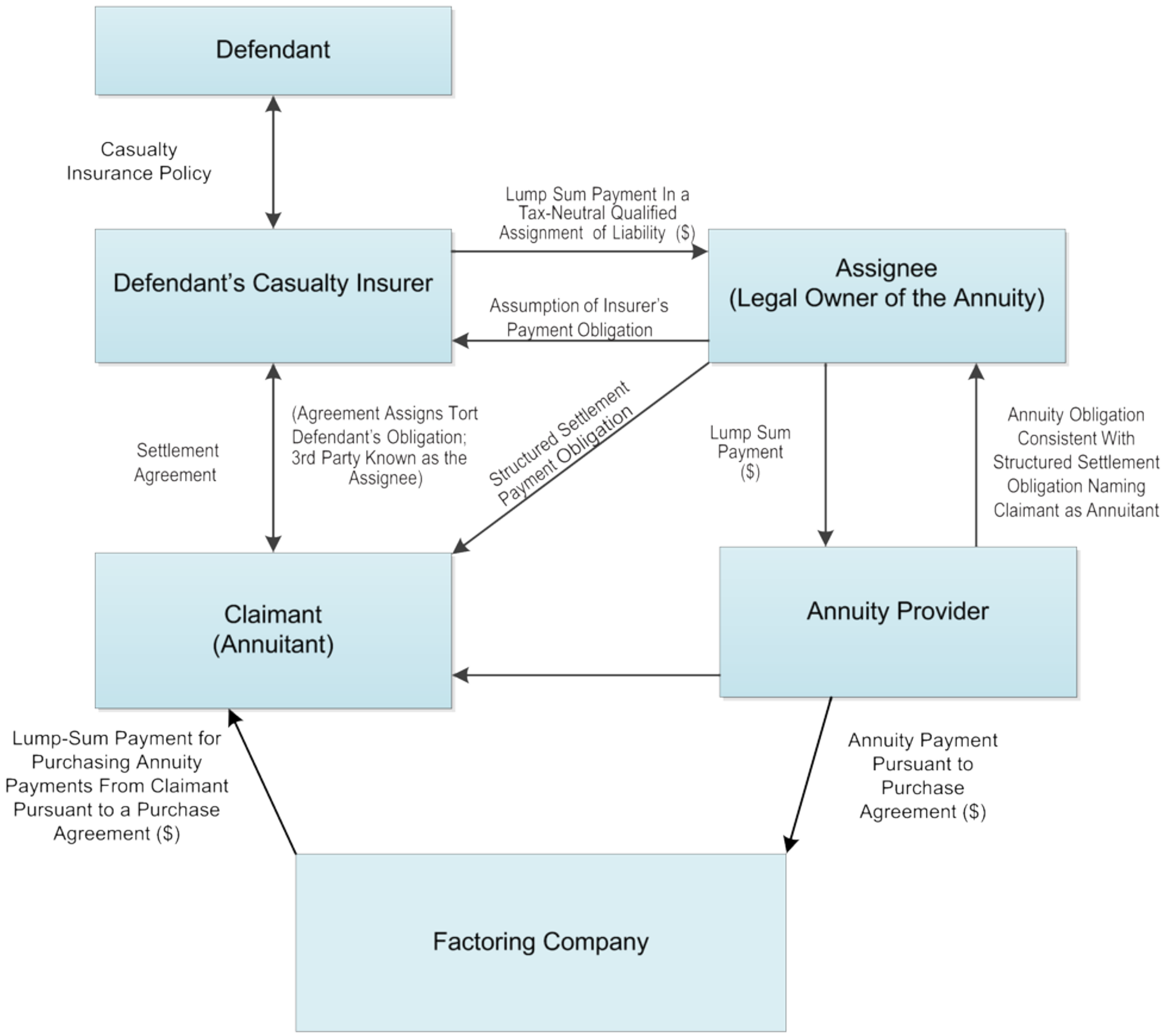
As a claimant's financial situation changes over time, he or she may wish to convert the annuity payments to a single, lump-sum payment. This can be accomplished by transferring all or a portion of the structured-settlement payment rights to a third party in return for such a single payment. Factoring companies can help the tort claimant, since their business purpose is to purchase and accumulate pools of structured settlements and, in some cases, efficiently finance their activities through securitization of such pools.

Nearly all states facilitate the transfer of annuity payments from claimants to factoring companies through a court-order process and have settlement transfer laws that conform to the Structured Settlement Protection Act, the model promulgated by the National Conference of Insurance Legislators (NCOIL). These laws generally contain features such as:

1. A separate, written disclosure statement required to be given to the claimant well in advance of the closing date of the transaction
2. Certification that the claimant has been advised in writing by the factoring company to seek independent, professional advice regarding the transfer, and has either received such advice or knowingly waived such advice in writing
3. Notice to certain parties that may be affected by the transfer
4. An itemized list of how the factoring company has calculated the present value of payments and gross amounts payable to the claimant in exchange for periodic payments
5. The net amount payable to the claimant after deducting all itemized commissions, fees, costs, expenses and charges
6. Court approval of the transfer, including a finding that the transfer is in the best interest of the claimant, taking into account the welfare and support of the claimant's dependents

Exhibit A.2 shows a structured settlement transaction that includes the role of the factoring companies that provide a way for claimants to monetize their annuity receipts.

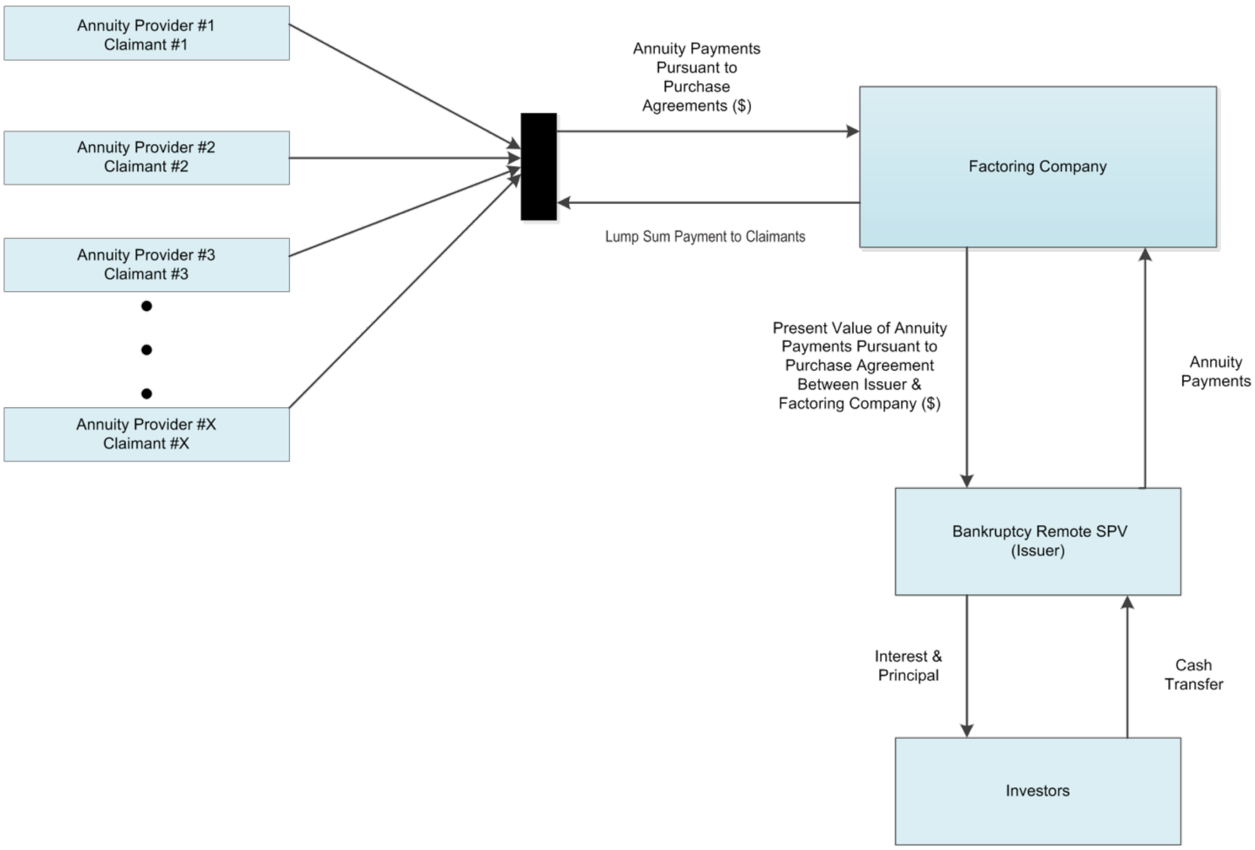
Exhibit A.2: Basic Structured Settlement Transactions (After Factoring)



Funding of Factoring Companies' Activities Through Securitization

Factoring companies fund their acquisition of annuity streams from claimants through their balance sheet or through loan facilities collateralized by the structured settlements. When enough structured settlements have been accumulated, the factoring companies can securitize them through a special-purpose vehicle (SPV), thus freeing their capital for further structured settlement activities. A.M. Best refers to the SPV as the issuer of the securities. **Exhibit A.3** shows a simplified diagram for the securitization of annuity streams.

Exhibit A.3: Simplified Securitization Diagram



B. Key Rating Factors

Credit Risk of Structured Settlements

Among the most important considerations for rating securities backed by structured settlements are the credit risks ascribed to the insurance companies involved in the transaction.

Insurer Defaults

A.M. Best assigns insurer default rates based on *Best's Idealized Issuer Default Matrix* as displayed in *Best's Insurance-Linked Securities and Structures Methodology* (BILSM).

If an insurer is not rated by A.M. Best but is rated by another rating agency, the rating of that rating agency, if known and available, will be applied to the insurer. An insurer that does not have a rating from any rating agency and that has not become impaired in the past will generally be assigned an Issuer Credit Rating (ICR) of "bb+". An insurer that does not have a rating from any rating agency and that has become impaired in the past (and recovered from such impairment) or an insurer that does not have a rating from any rating agency and that is under regulatory supervision will be assigned an ICR of "b." In such cases, an exception may be made subject to analytical judgment when: 1) the company has continued making payments on its contract obligations for the past three years or 2) insurance regulators have expressed confidence that all annuity obligations will be paid in full during the rehabilitation or runoff process.

Correlations

The annuity issuers in the structured settlement pools usually consist of large insurance companies. Given the size of these companies, it is reasonable to assume that their default probabilities are correlated, since they tend to hold similar investment assets. A.M. Best will either assume a heightened default rate to account for default correlations or assume a default correlation of 15% in the analysis.

Recoveries

In general, state guaranty funds cover up to USD 100,000 of cumulative cash flow on annuities. While some participants believe that annuitants are made whole in life insurance company impairments, a more careful examination of insurance company impairments and their resolutions will reveal that annuitants have a reasonable risk of diminished value of the cash flows if:

- There are reductions or delays in receiving promised cash flows or
- A new insurance company purchases the annuity book of business owned by the impaired insurance company and changes the terms of the annuity contract backing the structured settlement to the detriment of the annuitant

For these reasons, A.M. Best applies various recovery and payment-delay scenarios based on historical actions taken by guaranty funds and by insurance companies in impairments. A.M. Best assumes a recovery of 85% on defaults with a lag of one year.

Mortality Risk of Life-Contingent Structured Settlements

The most significant factor for evaluating life-contingent structured settlements is mortality risk – that is, the risk that claimants will die earlier than predicted, as earlier deaths result in a curtailment of the annuity cash flows. A.M. Best begins its evaluation of mortality risk by looking at the underwriting criteria used by the factoring companies in purchasing structured settlement cash flows. While there are no mortality tables just for structured settlements, there are experience studies that show excess death rates of structured settlement annuitants compared with standard annuity tables.

The issuer's main goal with regard to life-contingent structured settlements is to limit the types and levels of medical impairments allowed in the pool so as to manage the volatility of the claimants' life expectancies in the transaction. There are generally two ways issuers can determine the life expectancies of structured settlement annuitants. The issuers can either seek the help of medical underwriters – now used extensively in the life settlement field – to estimate life expectancies, or they can use in-house underwriting expertise.

Using Independent Medical Examiners

The lack of fully developed mortality tables for structured settlement annuitants makes it necessary to put a limit on the type of medical impairments that are allowed in the pool. One way to accomplish this is to have medical underwriters assess the mortality profile of each annuitant in a structured settlement pool to exclude those annuitants whose life expectancies have been shortened excessively by injuries that make life expectancies difficult to estimate. The life settlement industry uses medical examiners extensively, as further described below, to assess the life expectancies of individuals who desire to sell their policies in the secondary market. The same medical examiners can be used to evaluate the life expectancy of structured settlement annuitants.

Medical examiners use a numerical rating system developed by reinsurers to determine how an individual's mortality differs from a standard risk. In general, standard risk is given a value of 100%, which represents a unit of risk. The system assigns debits and credits to a life where debits are factors that increase a person's mortality over a standard risk and credits are factors that decrease a person's mortality over a standard risk. For example, an individual might have coronary heart disease that may be assigned a debit of 150%, and if that person has had bypass surgery to manage the ailment, he or she may earn credits of 25%. When the debits and credits are totaled, the person has a net debit balance of 125%. If a standard risk is considered to have a table rating of 100%, then this risk relative to standard will have a rating of 225%. This can be interpreted to mean that the probability that this individual will die is 125% higher than that of a standard risk — i.e. 225% of a standard risk. The percentage rating is commonly known as a mortality rating; this individual thus is said to have a mortality rating of 225%. It is important to recognize that one of the significant tasks of a medical examiner is to determine what constitutes a standard risk, since the mortality rating is a relative measure of the probability of death, not an absolute measure.

The standard risk class should represent a combination of risks that are substandard as well as risks that are above standard – not just risks of healthy individuals. To arrive at a life expectancy for most lives, the medical underwriter applies the mortality rating to its standard mortality, otherwise known as the "reference mortality experience." Since each medical underwriter develops its own mortality tables and has its own method of determining debits and credits to account for diseases, lifestyle and mortality improvements, it is difficult to derive a mortality curve for a given insured unless one knows the specific standard table used by that medical examiner. For this reason, one who receives a mortality rating from a medical examiner for an insured should also obtain the corresponding standard mortality table that is used to derive the life expectancy; otherwise, the data set is incomplete for the purposes of analyzing mortality risk.

A.M. Best views standard mortality tables that have been created with the help of qualified actuaries, especially those who are familiar with substandard annuities, favorably.

Summarized below is a list of information that a medical examiner may typically provide:

- Standard mortality tables upon which debits and credits are applied

- Mortality rating (i.e. 100 % + net debits and credits) that the medical examiner applies to its base mortality table to derive the life expectancy for each annuitant
- Life expectancy estimate for each annuitant
- Mortality or survivorship schedule for each annuitant (given medical impairments)
- Primary disease category for each annuitant, if one has been identified
- Report that validates the historical accuracy of the medical examiners' life-expectancy projections (i.e. actual to expected results)

Exhibit B.1 shows some of the diseases and injuries typically encountered by medical examiners in both structured settlement and life settlement transactions.

Exhibit B.1: Typical Impairments Seen by Medical Examiners

Injuries and Diseases	Examples
Spinal Cord	Paraplegia, Quadriplegia
Craniocerebral	Traumatic, Anoxic, Other
Burns	First to Fourth Degree
Birth Injuries	Asphyxia, Hypoxia
Cardiovascular	Coronary Artery Disease, Arrhythmia, Other (e.g. Heart Valve Disease)
Cancer	Lung, Prostate, Breast, Hematological, All Other Cancers
Cerebrovascular	Stroke, Carotid Artery, Transient Ischemic Attack
Dementia	Alzheimer's, Multi-Infarct
Respiratory Diseases	Emphysema, Asthma, Sleep Apnea, Chronic Obstructive Pulmonary Disease
Neurological Disorders (Excluding Alzheimer's)	Parkinson's, Lou Gehrig's Disease (ALS)
Diabetes	Type 1, Type 2
Other	Renal Failure, Peripheral Vascular, etc.

Using In-House Medical Underwriting

Using in-house medical underwriting as opposed to using medical examiners may be appropriate since the demographics of claimants in structured settlement transactions are quite different from those in current life settlement pools who are medically underwritten by medical examiners. Life settlements are generally for those ages 65 or older, whereas the median age of the annuitants in purchased structured settlements is approximately 44 years. Additionally, those selling their insurance policies in the current life settlement market usually own polices with face values of USD 250,000 or higher. Claimants in structured settlements, on the other hand, generally have little or no insurance, indicating that they are not as wealthy as the insureds in life settlements. Since not all medical examiners have experience in estimating the life expectancies of the types of individuals that enter structured settlements, A.M. Best generally accepts in-house medical underwriting and expects to review the following information:

- Documented underwriting standard

- An evaluation by actuaries of the underwriting procedures used by the issuer in evaluating the life expectancies of the claimants and a determination as to whether it produces debits and credits similar to independent medical underwriters
- Information on the in-house underwriting process and a determination as to whether it produces debits and credits similar to independent medical underwriters and if there is a debit threshold beyond which claimants are excluded from the pool
- Documentation on the type of interview conducted (via phone, e-mail, or in person), if any, as part of the evaluation process
- Basic guidelines for excluding cases where it is difficult to evaluate life expectancies, such as exclusions for claimants who take high doses of certain medications, have certain injuries, such as cerebral and spinal cord injuries, are in a permanent vegetative state, and/or whose mortality ratings are beyond certain debit thresholds
- Verification of the information provided by the claimants for purposes of determining mortality risk
- Methodology for creating underwriting tables used to evaluate the claimants' life expectancy
- Determination as to whether any annuity or population tables were used (and the circumstances under which expert opinion is sought regarding certain medical conditions for the purpose of establishing life expectancies)
- Details on how mortality improvements are included in the determination of the claimants' life expectancy
- Maximum or minimum age allowed for inclusion in the transaction
- The extent to which the medical records of claimants are sought and used for the underwriting process
- Other significant information related to the underwriting of life-contingent structured settlements

Mortality Risk Mitigation

One way to manage mortality risk is through a life-contingent insurance policy that provides the issuer with supplemental cash flows until a fixed date, regardless of whether the annuitant is alive or dead. The insurer effectively assumes the risk of the annuitant's early death. In essence, the insurer fixes the date of death of the annuitant for modeling purposes. A.M. Best will review the insurance policy to ensure that: 1) the policy is fully backed by a rated entity (or parent with a "cut-through" provision); 2) the obligation to pay claims does not have unreasonable loopholes whereby claims can be denied easily; and 3) the policy will not lapse easily.

A.M. Best's considerations regarding the appropriateness of the insurer include: 1) a minimum insurer ICR of "a-" or higher and 2) evidence of timeliness of payments by the insurer for covered obligations.

General Underwriting Standards of Factoring Companies

The issuers of securities backed by structured settlements rely on the underwriting standards of the factoring companies that purchase annuities from claimants. Clean underwriting standards and strict compliance with laws of each state where the structured settlements were originated have reduced the risk of challenges to the periodic payment assignments made by claimants (and their heirs or beneficiaries) and insurance companies. While the existence of court orders before a transfer reduces the risk of such challenges, transferees generally ensure that their origination criteria consider the following issues:

- The general underwriting guidelines for purchasing the structured settlements – including the underwriting guidelines for choosing which life-contingent structured settlements to purchase
- The possibility that the annuity cash flows may be encumbered by the bankruptcy of the claimant or by any liens on such cash flows
- The possibility that the estate of the tort claimant will be challenged by a spouse, relatives and dependents of the claimant
- Screening for income level and physical disability considerations so as not to cause undue hardship for low-income and disabled tort claimants who should maintain annuity cash flows to cover basic living and medical expenses
- Screening for tort claimants such as minors or adults who cannot legally enter contracts
- The possibility that the structured settlement may affect the claimant's eligibility for Medicaid and other programs

Transaction Review

The following items are expected to be reviewed as part of the rating analysis on the pool of structured settlements:

- Clear underwriting standards for both period-certain and life-contingent structured settlements
- Confirmation that the insurance companies issuing annuities have an ICR of "bbb-"or higher
- Confirmation that structured settlements are established pursuant to a court order
- Limitations on the present value of the structured settlements related to any one insurer not to exceed 15% of the total face value of the pool as a concentration of more than 15% would result in additional stresses applied in the analysis (exceptions may be made for insurers with "aaa" ICRs subject to analytical judgment)
- For life-contingent annuities, A.M. Best expects to review:
  - The periodic cash flows for each annuitant being purchased by the issuer

  - The life expectancy and mortality ratings (based on the claimant's medical records, if any) from at least one medical examiner for each individual if issuer does not use in-house underwriting that has been evaluated by professional actuaries or consultants
  - Results of the issuer's in-house underwriting for each claimant
  - Details on the annuitants, including age, gender and smoking status
  - The state in which the court order was issued for each annuitant as a concentration of more than 8% in any state would result in an additional stress applied to the analysis
  - HIPAA-compliant medical release forms for each annuitant, if legally mandated, provided by the insurer
  - The mortality tables (and the adjustments) used by the factoring company and/or the issuer to value the structured settlements
  - Identification and classification by the factoring company of the physical injuries, if any, that gave rise to the tort or workers' compensation claim
  - Guidelines of the collateral manager as to the types of structured settlements to include in the collateral pool – e.g., gender, age, state distributions, etc.
  - Procedures for determining whether the annuitant is dead or alive
  - The mortality tables assumed by the issuer in analyzing the transactions and the rationale for using such tables
  - Categorization of impairments, if any (see Exhibit B.1)
  - The life-contingent insurance agreement, if any, between the issuer and an insurer

- For period-certain annuities, A.M. Best expects to review periodic cash flows purchased by the issuer aggregated by each insurance company in the pool
- The legal name for each insurance company in the pool and its rating
- Historical data from the factoring companies' business, such as defaults on annuity payments, recoveries, late payments and payment errors
- Historical data from the servicer on diversions
- Data on mortality of structured settlements handled by the servicer
- Identification of a master servicer that provides the following duties (on behalf of the trustee):
  - Receiving and posting payments from annuity companies
  - Making all payments to securitization constituents (bondholders as well as service providers)
  - Performing transaction accounting and interacting with the annuity companies in connection with administrative issues
  - Tracking deaths
  - Performing analysis on the performance of the issuer's collateral pool

- Identification of a collateral manager that will:
  - Determine what structured settlements will be included in the securitization (particularly when considering inclusion of life-contingent structured settlements)
  - Determine what actions to take in the event decisions have to be made about the annuities after an insurance company impairment
  - Make other decisions regarding the servicing of the pool of structured settlements in the event the current servicer has to be replaced
- Identification of a backup servicer, trustee, auditors, lock box bank, legal counsel, investment banks and other service providers in the transaction
- Indentures and other legal documents pursuant to the transaction

C. Modeling and Stress Testing

At its most basic level, A.M. Best's Life Contingent Simulation Model (LCSM) uses the Monte Carlo simulation technique to generate the cash flow associated with every structured settlement after considering the appropriate credit risks of the insurance companies that have issued the annuities and, if the structured settlement is life-contingent, the appropriate mortality profiles of the annuitants.

For life-contingent structured settlements, the LCSM draws random numbers (given the mortality profile of an annuitant) to determine when the annuitant has died. As long as the annuitant is alive, the issuer receives the annuity payments until the end of the period in which the structured settlement annuity cash flows have been purchased by the issuer. The payments stop when the annuitant is dead. At the same time, the LSCSM draws a random number (given the default rates of insurers) to determine whether the insurance company that issued the annuity is in default. If the insurance company goes into default before the annuitant dies, the annuity payment is missed in the year of default but resumes the next year after a 15% reduction in the annuity payments from that year until the annuitant dies. If the insurance company goes into default after the annuitant dies, the default has no effect on the cash flows to the issuer.

For period-certain structured settlements, the LCSM draws random numbers to determine when the insurance company that issued the annuity is in default. If the insurance company goes into default, the annuity payment is missed in the year of default but resumes the next year after a 15% reduction in the annuity payments.

Stress testing of key parameters is performed on the transaction to assess the impact on defaults of the securities. The parameters stressed in the modeling of the transaction include the mortality rates, insurance carrier defaults and recovery rates.

D. The Assignment of a Rating

The modeling described above is performed for a large portfolio consisting of both period-certain and life-contingent. For each trial in the simulation, the LSCM aggregates the cash flows (annuity payments); makes payments as prescribed by the transaction's waterfall; and determines whether the net cash flows are sufficient to pay interest and principal when due. If payments are missed because of inadequate cash flow, the LCSM records a default. The ultimate output of the LCSM is the default rate–the total number of defaults for all trials divided by the number of trials. This default rate is then tied to *Best's Idealized Issue Default Matrix* as displayed in the BILSM, which shows the default rates associated with issue credit ratings. The credit quality of the securities is based on the long-term issue credit rating scale.

E. Surveillance

As part of the surveillance activities with regard to structured settlement securitizations, the information that A.M. Best expects to review includes, but is not limited to, the following:

- Date of death of any annuitant and the date the death was reported to the issuer
- Insurance company impairments (i.e. insolvency, rehabilitation, cease and desist order)
- Changes in annuity cash flows – whether due to insolvency, changes in crediting rates or other reasons
- Reconciliation as to why the cash flows deviate from original projections
- Payments, if any, made by the insurer to hedge the life-contingent structured settlements
- Violations of underwriting criteria discovered by the collateral manager, back-up servicer or other service providers
- Periodic updates of the remaining cumulative annuity cash flows
- Details of defaulted/written-off annuity cash flows

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METHODOLOGY

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