

January 23, 2012

### BCAR Credit for Contingent Capital Facilities

- SPV fully funded
- Mandatory exercise of put option
  - Date specific or event trigger
- Funds downstreamed to operating company
- Credit cap is 10% of equity capital
- Counts toward financial leverage calculation

### Additional Information

#### Criteria:

Understanding BCAR

A.M. Best's Ratings & the Treatment of Debt

#### Analytical Contact

Duncan McColl, CFA  
+1 (908) 439-2200 Ext. 5826  
Duncan.McColl@ambest.com

A.M. Best will consider feedback from any interested party prior to publishing its methodology. Written comments can be submitted by e-mail to [methodology.commentary@ambest.com](mailto:methodology.commentary@ambest.com), no later than Feb. 23, 2012.

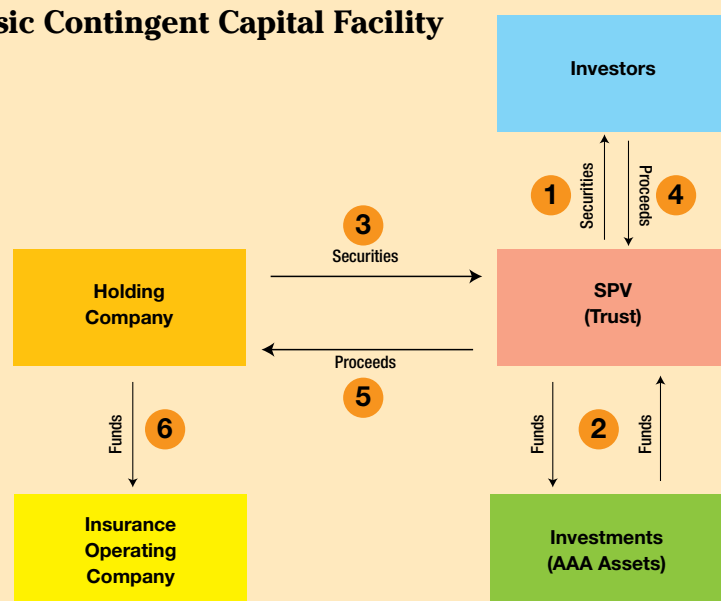
This methodology is available at  
[www.ambest.com/ratings/methodology](http://www.ambest.com/ratings/methodology)

## Draft: Analyzing Contingent Capital Facilities

A primary concern for an insurance organization is its need to maintain an amount of capital that is commensurate with the entity's risk profile. For companies with strong balance sheets, robust earnings and limited opportunities for growth, effective capital management may involve returning a portion of that capital via stock buy-backs or the retirement of debt. While A.M. Best does not advocate aggressively removing capital from the balance sheet, too much capital can be problematic in that it exerts pressure to grow and expand operations at a pace that may not be prudent under certain market conditions.

During periods when the market is flush with capital, stock buy-backs become a popular mechanism for companies to achieve an appropriate balance between capital and risk. However, with a diminished capital cushion, management teams become concerned with their ability to take advantage of future market opportunities. A favorable business opportunity such as an acquisition or new line of business may not wait for the company to raise capital. Moreover, under a shock-loss scenario such as a catastrophe, companies may find it difficult to recapitalize afterward at a reasonable cost. This refers to the concept of financial flexibility, which goes hand in hand with capital management and is a key component of A.M. Best's rating analysis.

### Basic Contingent Capital Facility



1. SPV is formed and issues contingent notes to investors.
2. SPV invests funds in highly rated, liquid assets.
3. Holding company exercises put option, issues securities to SPV.
4. Contingent notes replaced with newly issued securities.
5. SPV liquidates asset and proceeds transferred to holding company.
6. Funds downstreamed to operating company.



## Credit for Contingent Capital Facilities

Some management teams have taken proactive steps toward enhancing their financial flexibility. One popular approach is through contingent capital facilities, which allow companies to preset the terms and conditions of future capital-raising initiatives. Based on the provisions of the facility, A.M. Best will consider giving qualitative and, in some cases, quantitative credit for contingent capital. It should not be inferred, however, that A.M. Best expects all highly rated companies to maintain contingent capital facilities. This is simply one of many ways insurance organizations can demonstrate their financial flexibility.

Considering the recent interest in contingent capital, A.M. Best has determined

which provisions likely would warrant credit in Best's Capital Adequacy Ratio (BCAR), which measures risk-adjusted capital available to meet policyholder obligations. Generally, more credit is given to fully funded facilities, where the special-purpose vehicle (SPV) holds highly rated, liquid securities that the sponsor can access on short notice. A.M. Best also looks favorably on facilities that require put options to be exercised when certain events occur, such as a catastrophe loss (i.e. natural, man-made or pandemic). If the put option rests with the holding company, credit is given if the holding company is obligated contractually to downstream the funds to its insurance operating subsidiary. In cases where the put option involves a hybrid issuance at the operating company level, the maximum available credit would be 90%. This could reach 100%

## Case Study – Treatment of Contingent Capital Facility

### Holding Company Capital Structure

Debt	\$600
Hybrid	\$200
Equity	\$1,800
<b>Total Capital</b>	<b>\$2,600</b>
Contingent Capital	\$400*

\*operating company has put option to issue a hybrid security

### Operating Company BCAR Treatment

Assuming facility meets guidelines for receiving credit in BCAR (see Table).

	Baseline	Add Contingent Capital Credit
Adjusted Capital	\$2,800 <sup>1</sup>	\$3,060 <sup>3</sup>
Required Capital	\$2,000 <sup>2</sup>	\$2,050 <sup>4</sup>
BCAR Score	140	149

1 Adjusted Capital – Baseline: Starting Equity Capital is \$2600 (assumes all holding company capital downstreamed as equity to operating subsidiary) plus Adjustments totaling \$200 (loss-reserve equity, fixed-income equity, deduction for after-tax net PML) = Adjusted Capital of \$2800.

2 Required Capital based on the risk profile of the company.

3 Figure reflects addition of \$260 (90% of \$400 from contingent capital hybrid issuance is \$360; subject to cap of 10% of equity capital = \$260).

4 Required Capital with Contingent Capital Credit includes additional investment risk of new assets.

### Financial Leverage Treatment

Assume security issued via contingent capital facility qualifies as a hybrid and gets 90% credit – subject to 20% total capital cap (\$600).

#### Unadjusted for Equity Credit

Debt + Hybrid + Contingent/Total Capital 600+200+400/3,000 = 40%

#### Adjusted for Equity Credit

Debt + Hybrid charge + Contingent charge/Total Capital 600+20+40/3,000 = 22%

20% cap on equity credit not applicable because \$540 < \$600.

if the facility involves the issuance of equity securities. However, since limitations are placed on all forms of soft capital, in cases where credit is given in the published BCAR model, the maximum credit allowance is 10% of equity capital. Also, where credit is given on a pro forma basis – that is, prior to exercising the put option – the securities to be issued pursuant to the contingent capital facility will count toward the financial leverage calculation.

Facilities that do not conform to these specifications (i.e. the SPV is not fully funded; triggering the facility is subject to management discretion) still can receive credit on a qualitative basis, and on a quantitative basis toward the stress-tested capital requirement. Here, the securities to be put to the SPV would not count toward the financial leverage calculation until actu-

ally issued. The cap on credit given in the stress-tested BCAR would be increased to 35% of equity capital.

## Conclusion

Contingent capital facilities provide companies with financial flexibility and protect the balance sheet against the unexpected. Alternatively, they can enable a company to seize a market opportunity in a timely fashion, without first having to test the appetite of the capital markets. Plus, they allow a company to establish the terms and conditions of future capital-raising activities up front, which reduces the chances of having to pay a risk premium under adverse conditions. A.M. Best's rating analysts are available to discuss required capital levels and can give feedback on the rating implications of utilizing a contingent capital facility.

Published by A.M. Best Company

## Methodology

CHAIRMAN & PRESIDENT **Arthur Snyder III**

EXECUTIVE VICE PRESIDENT **Larry G. Mayewski**

EXECUTIVE VICE PRESIDENT **Paul C. Tinnirello**

SENIOR VICE PRESIDENTS **Manfred Nowacki, Matthew Mosher,  
Rita L. Tedesco, Karen B. Heine**

**A.M. BEST COMPANY**  
**WORLD HEADQUARTERS**  
Ambest Road, Oldwick, N.J. 08858  
Phone: +1 (908) 439-2200

**NEWS BUREAU**  
830 National Press Building  
529 14th Street N.W., Washington, D.C. 20045  
Phone: +1 (202) 347-3090

**A.M. BEST EUROPE RATING SERVICES LTD.**  
**A.M. BEST EUROPE INFORMATION SERVICES LTD.**  
12 Arthur Street, 6th Floor, London, UK EC4R 9AB  
Phone: +44 (0)20 7626-6264

**A.M. BEST ASIA-PACIFIC LTD.**  
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong  
Phone: +852 2827-3400



Copyright © 2012 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site [www.ambest.com](http://www.ambest.com).

Any and all ratings, opinions and information contained herein are provided "as is," without any expressed or implied warranty. A rating may be changed, suspended or withdrawn at any time for any reason at the sole discretion of A.M. Best.

**A Best's Financial Strength Rating – Insurer** is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

**A Best's Debt/Issuer Credit Rating** is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

A.M. Best does not offer consulting or advisory services. A.M. Best is not an Investment Adviser and does not offer investment advice of any kind, nor does the company or its Rating Analysts offer any form of structuring or financial advice. A.M. Best does not sell securities. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

A.M. Best's special reports and any associated spreadsheet data are available, free of charge, to all *BestWeek* subscribers. On those reports, nonsubscribers can access an excerpt and purchase the full report and spreadsheet data. Special reports are available through our Web site at [www.ambest.com/research](http://www.ambest.com/research) or by calling Customer Service at (908) 439-2200, ext. 5742. Some special reports are offered to the general public at no cost.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.

**SR-2008-M-129**