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Criteria Application: Evaluating Insurers' TALF Investments

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(Editor's Note: This article discusses the "Principles Of Corporate And Government Ratings," published June 26, 2007, on RatingsDirect at www.ratingsdirect.com and Standard & Poor's Web site at www.standardandpoors.com. More specifically, it presents criteria on Standard & Poor's methodology and assumptions for evaluating the financial leverage and capital adequacy of insurance companies.)

With the introduction of the Federal Reserve Bank of New York's Term Asset-Backed Securities Loan Facility (TALF), many insurers are considering investing in eligible collateral funded by TALF loans. The Federal Reserve is establishing TALF to ease the current strain in the asset-backed securities (ABS) market, which limits the availability of credit to households and small businesses. To induce investors to purchase certain classes of ABS, the Federal Reserve Bank of New York (FRBNY) will initially make up to \$200 billion in loans available under TALF. These loans will be non-recourse to the borrower and secured by eligible collateral owned by the borrower. Generally, eligible collateral will include newly or recently issued U.S. dollar-denominated cash ABS that have a long-term credit rating in the highest investment-grade rating category ('AAA' under Standard & Poor's Ratings Services' scale) from two or more nationally recognized statistical rating organizations (NRSRO's) and do not have a long-term credit rating below the highest investment-grade rating category from a major NRSRO.

Insurers looking to participate in the TALF program would pledge eligible collateral to the Federal Reserve and in turn borrow non-recourse TALF loans equal to the amount of the collateral pledged less a collateral haircut established by FRBNY. By making TALF loans non-recourse to the borrower, FRBNY is limiting the borrower's losses to the collateral haircuts.

As insurers consider participating in the TALF loan program, Standard & Poor's has been asked whether these companies' TALF loans would be viewed as financial leverage or operating leverage. Financial leverage is generally meant to measure the amount of debt or debt-like funding that is used by an insurer to meet its general capital needs. Alternatively, insurers might use debt or debt-like instruments to fund a discrete pool of financial assets—such as bonds or other high-quality, fixed-interest instruments. In these cases, Standard & Poor's may treat this debt as operational leverage when there is strong asset/liability matching or active risk management employed and when there is little to no risk that the assets will not be able to repay the funding.

Under Standard & Poor's criteria published in Ratings Direct: "Insurance Company Debt: Operating Leverage or Financial Leverage?" (April 19, 2004), operational leverage is debt incurred in the process of funding assets for financial-intermediation purposes where Standard & Poor's evaluates that the pool of assets backing the borrowing will be sufficient to pay all returns on the interest and principal of that debt with insignificant risk of any of the issuer's other assets being called on to make such payments. Given that TALF loans will be non-recourse to the borrowers, Standard & Poor's likely will not treat these insurer borrowings as financial leverage. They are expected to be included as operating leverage in our evaluation of the insurers.

This does not mean that we believe that participation in the TALF program is without risk for insurers. The risk they would retain as investors is the potential loss on the underlying ABS up to the full amount of the TALF-ascribed collateral haircut. For insurance operating companies holding these securities, Standard & Poor's

expects it will assess risk-based capital factors against all collateral pledged by insurers under the TALF program commensurate with its risk assessment of the collateral. The maximum risk charge will be limited to the maximum loss exposure. As an example, if a collateral pool is \$100 million and the TALF collateral haircut was 5%, the maximum possible loss to the insurer is \$5 million under the TALF program. Therefore, if under Standard & Poor's existing capital model criteria, the risk factor is 7% based on the characteristics of the collateral, the pool's capital charge under Standard & Poor's criteria of \$7 million would effectively be capped at \$5 million. Conversely, if Standard & Poor's capital factor is less than 5%, the capital needs associated with this investment would also be lower.

Related Research:

-- "Risk-Based Insurance Capital Model," Sept. 11, 2008, RatingsDirect and www.standardandpoors.com.

-- "Insurance Company Debt: Operating Leverage or Financial Leverage," April 19, 2004, RatingsDirect and www.standardandpoors.com.

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