



Methodology

*Rating U.S. Insurance Premium Finance  
Securitizations*

DECEMBER 2009



*Insight beyond the rating.*

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Related Research: Legal Criteria for U.S. Structured Finance Transactions dated September 2009

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This methodology replaces and supersedes all related prior methodologies. This methodology may be replaced or amended from time to time and, therefore, DBRS recommends that readers consult [www.dbrs.com](http://www.dbrs.com) for the latest version of its methodologies.



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# Rating U.S. Insurance Premium Finance Securitizations

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## Executive Summary

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DBRS is requesting comments on the proposed rating methodology for U.S. asset-backed (“ABS”) transactions backed by insurance premium finance loans originated for the purposes of paying premiums on property and casualty insurance. Comments should be received on or before January 15, 2010. Please submit your comments to the following e-mail address: [dbrsinsurancepremiumcomments@dbrs.com](mailto:dbrsinsurancepremiumcomments@dbrs.com). DBRS will publish a final methodology following the review and evaluation of all submissions.

The primary risks in ABS secured by insurance premium finance loans relate to (i) the insurance carriers who provide the insurance and rebate unearned premiums to the finance company, in the event a policy is cancelled prior to the fulfillment of the policy term and (ii) the quality of servicing which includes billing and collecting on outstanding loans and pursuing unearned premiums from insurance carriers in the event of non-payment of an outstanding loan. The loans serve as collateral for the ABS and are used to finance the premiums to be paid by an individual or corporate obligor typically under traditional property and casualty insurance contracts. Certain other types of insurance, such as worker’s compensation, have also served as collateral for insurance premium finance loan transactions.

The methodology described in this report includes an analysis of the following key analytical factors:

- Type and structure of the underlying loans making up the collateral for a transaction;
- Credit quality (claims paying ability) of the insurance carriers providing the insurance;
- Transaction capital structure, proposed ratings and credit enhancement;
- Capabilities of the finance company to originate, underwrite and service the receivables; and
- Transaction legal structure and opinions.

Ratings assigned to ABS secured by a pool of insurance premium finance loans correspond to the level of credit enhancement, which may include subordination of lower or non-rated classes of notes, overcollateralization or funded cash reserves.

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## Asset Description

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### INSURANCE PREMIUM FINANCE LOANS

Insurance premium finance ABS are often structured as medium term notes (MTNs) backed by the payment streams from financing agreements (i.e. loans related to obligors who borrow funds to pay premiums on insurance policies). These securities are typically issued by rated, short-term credit facilities financed by banks or are issued as term securities from bankruptcy-remote special purpose vehicles. In all cases, insurance premium loans and related receivables, or the entire beneficial interest therein, are transferred on a true-sale basis.

Insurance premium financing is structured as a loan extended to an obligor to pay for the premiums due on property and casualty insurance. Given the costs of policy premiums, there are generally three reasons for an obligor to consider premium financing: 1) a significant portion of the obligor’s assets may be tied up in other investments, 2) the lump sum payment is unaffordable, or 3) the financing arrangement may include an attractive (i.e. “teaser”) rate.

Often, the premium is required to be paid in a lump sum by a lender (typically a finance company) to an insurance carrier. The amount of the premium is the cost to the obligor for a specific insurance contract. The financing arrangement with the obligor requires monthly or periodic payments to the lender to repay



the lump sum premium payment made by the lender to secure the insurance policy with an insurance carrier. The financing arrangement also provides that the lender is entitled to any unearned premium due from the insurance carrier in the event of policy cancellation. The documentation may also include a limited power of attorney to permit the lender to cancel coverage under the policy.

In the financing arrangement, it is customary for the obligor to make a down payment at the time of financing of between 5% and 25%. While all or a portion of the down payment is typically retained by the third-party agent network as a commission, it creates immediate overcollateralization between the unearned insurance premium and the loan extended to the obligor to pay for the insurance premium. It is important to note that the specifics of the insurance coverage, including the terms and cost, are typically negotiated and agreed upon without the involvement of the finance company. The finance company is solely involved in the process of financing the pre-arranged insurance coverage and has little incentive with regards to selling or sizing the coverage. The finance company's business flow is derived from relationships with agents, brokers, or administrators that work with or on behalf of the policy providers.

*How an insurance premium finance loan is established:*

1. A person or company has a need for property and casualty insurance policy for a car which they own;
2. The person or company arranges for an insurance policy with an insurance company that underwrites the policy;
3. The person or company is given the option of paying the lump sum payment for the full value of the policy premium up front or financing the premium over time through a finance provider;
4. If the person or company chooses to finance the premium over time, the person or company will apply for the financing;
5. The finance company often relies on an agent network to generate lending opportunities, with the agent performing initial underwriting on the person or company. In the event the obligor fails to pay on the financing arrangement, the finance company looks to the insurance carrier, which has underwritten the policy, to cover its "loss". Therefore, the finance company may place less emphasis on the creditworthiness of the obligor under its financing loan;
6. The person or company enters an arrangement for the premium financing and becomes an obligor under the financing loan. The key characteristics of the financing loan include:
  - a. the amount of the financing does not exceed the lump sum value of the premium payment that will be "fronted" by the finance company to the insurance carrier;
  - b. the obligor makes a down payment typically between 5%-25% of the total premium financing amount, and;
  - c. the obligor pays the balance of the finance loan in equal installments over a period of time that is typically shorter than the term of the insurance policy (typically  $\frac{1}{2}$  to  $\frac{3}{4}$  as long);
7. The finance company makes a lump sum payment to the insurance carrier to pay the full premium due on the policy at inception;
8. The obligor makes the down payment to the finance company and begins the installment payments on the finance loan; and
9. The finance company services the monthly collections from obligor.

## **THE ECONOMICS OF INSURANCE PREMIUM FINANCE AND UNEARNED PREMIUM**

In all cases, the premium finance loan amortizes faster than the unearned insurance premium that has been paid (e.g. a six month premium finance loan versus one year of insurance coverage). The term of the premium finance loan is dependent upon the term of the insurance policy in order to provide protection for the finance company by creating excess premium coverage. Generally, the term for premium finance is one-half to three-quarters as long as an insurance policy. Consequently, at the time the premium finance loan is paid in full, a significant portion of the unearned insurance premium will still exist and continue to amortize. This creates an excess unearned premium amount, where the value of the unearned insurance

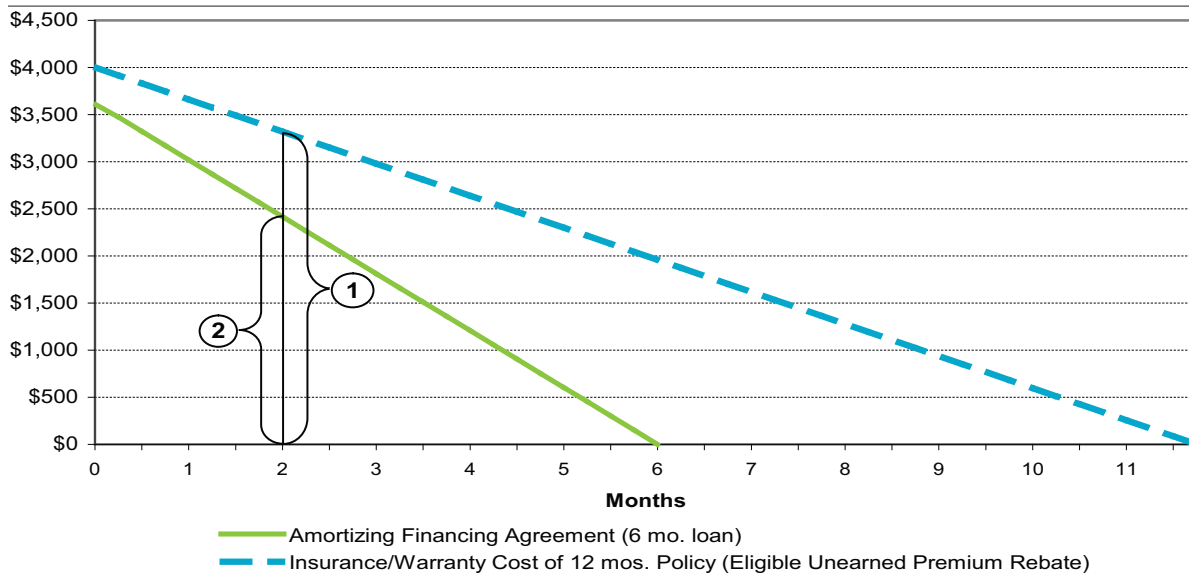


premium exceeds the remaining financed amount.

The primary risk to a transaction occurs when an obligor fails to pay on the premium financing loan and the corresponding policy must be cancelled. An obligor is generally entitled to cancel the policy at any time. In such an event, the insurance carrier is obligated to reimburse a pro rata share of unearned premium paid under the insurance contract to the lender. When the policy is cancelled, the insurance carrier ceases earning the premium that had been paid by the finance company. The finance company is entitled to be rebated the remaining balance of the premium (i.e. unearned premium). Therefore, quantitatively, the risk to the finance company equals the difference between the amount of unearned premium the finance company is owed at cancellation and the aggregate amount of the outstanding loan.

As shown in the graph below, an insurance policy covering 12 months may be financed over a 6 month term. The premium is paid by the finance company up front and, as shown by the dotted line, amortizes linearly over the full term of the policy. The solid line shows the premium finance loan amortizing at a faster rate than the amortization of the premium. As a result, excess unearned premium grows as the premium loan amortizes (the delta between the dotted and solid lines). Given that an obligor may cancel the insurance contract at any time, the lender benefits from the accumulation of excess unearned premium.

**Illustration of Unearned Premium**



The graph above assumes an obligor purchases a property and casualty insurance policy for \$4,000 with a down payment of \$400 (or 10%) and an insurance premium loan of \$3,600 casualty insurance policy. At inception, the policy premium has been paid for by the obligor, but no insurance has been provided, thus the premium is unearned. As time passes, the insurance policy is used and the related premium is earned. The insurance premium loan, originally \$3,600, amortizes over time as the obligor makes its scheduled payments. The period of amortization for the insurance premium loan, which is shorter than the related insurance policy term, is six months. If the obligor fails to make a scheduled payment, the policy will be cancelled. The example assumes that the insurance policy is cancelled at the end of month two of the premium loan. At the time of cancellation, the amount of unearned premium owed to the finance company is \$3,333 and is represented by the area below the dotted line as #1. The amount of the premium finance loan that remains outstanding is \$2,400 and is represented by the area below the solid line as #2. Although the finance company has a potential loss of \$2,400 on the premium finance loan, by virtue of the premium loan amortizing faster than the policy term, the finance company is protected



against such loss by the amount of the rebate of unearned premium (which exceeds the amount owed on the premium loan).

The “worst case” scenario is if a policy is cancelled on “day one”, when the finance company has its full premium lump sum payment paid to the insurance carrier and the premium finance loan has not begun to amortize. Under such circumstances, however, the risk of loss is mitigated by the amount of down payment received by the finance company from the obligor, as well as the subordination, overcollateralization and reserve fund available to an outstanding series in the transaction structure. Also, it is common for finance companies to net out certain amounts of unearned premium they are owed on existing cancelled policies from new premium business they are paying out to an insurance company.

## INSURANCE CARRIER RISK

The main source of recovery in a premium finance arrangement is the insurance carrier that provides the insurance policy. Therefore, the claims paying ability of the insurance carrier is a primary analytical consideration.

DBRS reviews the claims paying ability ratings of the insurers and the diversity of such insurers in a transaction. Transactions typically include pools of loans of 20,000 or more relating to policies issued by 100 or more insurance carriers with concentration limits set to protect against exposures to insurers representing high concentrations of receivables, low ratings, or other concentrations that introduce additional risk in the transaction. Under most circumstances, lack of diversity amongst insurers or high concentrations of lower rated insurers could limit the rating of the transaction as the ultimate source of payment is the rebate of unearned premium from the insurers.

Should a carrier become insolvent, the finance company would file a claim allowing them to be reimbursed for the unearned premium. The finance company would file as a general creditor of the insurance company. Insurance codes vary at the state level, but in general, balances due from an insolvent domestic carrier are fully covered by guaranty funds managed by the department of insurance in each state. Consequently, if the insurance carrier defaults (in the instance of U.S. carriers) the respective state’s insurance guarantee funds will back the insurance carrier’s obligations. While likelihood of recovery is increased due to presence of such funds, the timing of payment is still quite variable and can be subject to extended delays.

As a regulator, a state department of insurance can generally seek three types of orders for carriers facing financial distress or insolvency: supervision, suspension, or liquidation. An order of liquidation is the most severe of the three and is issued only by a state court. Once granted, an order of liquidation cancels all outstanding policies and outstanding claims are processed by the guaranty association.

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## Transaction Structure

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### REVOLVING OR TERM; CONCENTRATION LIMITS

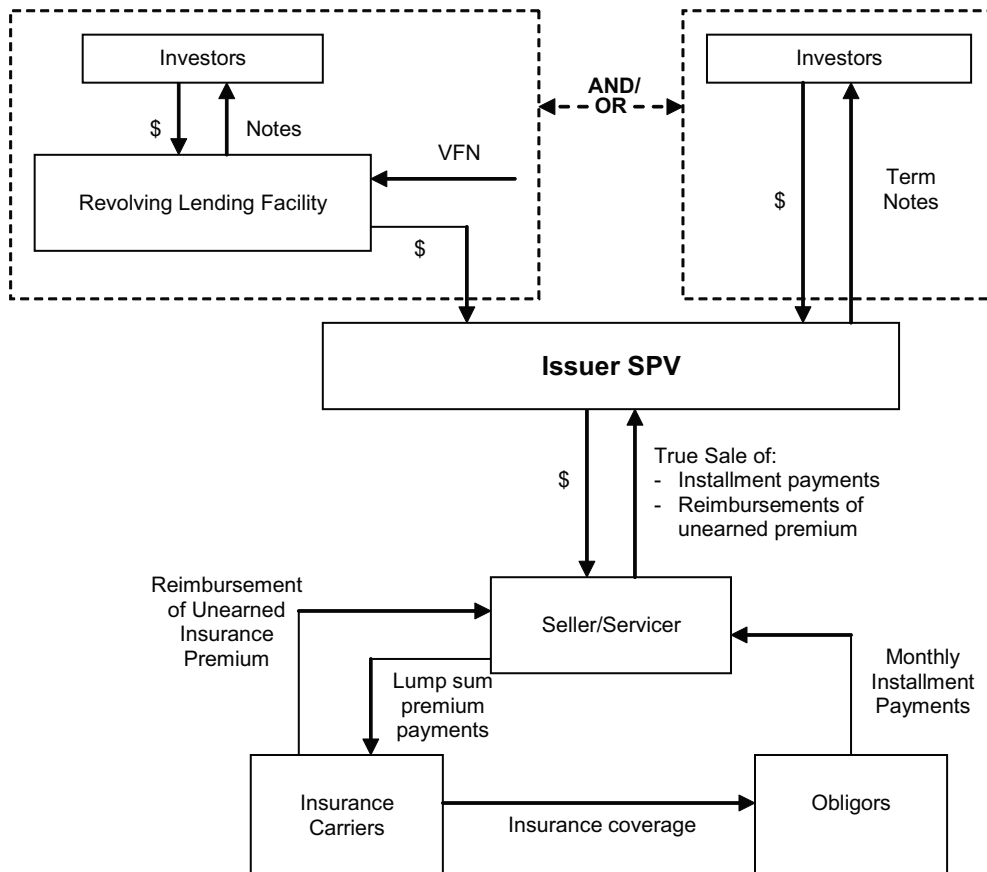
Typically, insurance premium finance ABS transactions are structured as revolving lending facilities held on-balance sheet at large banks or master revolving trusts funded in asset-backed commercial paper (ABCP) conduits, with the ability to issue term series securitizations. These master revolving trusts are typically structured utilizing dynamic credit enhancement with a large pool of insurance premium loans collateralizing all series of notes. For each series, interest and principal payments are allocated from collections based on the proportionate size of the series note balance (including any overcollateralization allocable to such series). The insurance premium loan pool balance that exceeds that which is allocable to any outstanding series of notes represents the issuer’s interest.



In a typical structure, the seller/servicer originates loans to finance insurance premiums to obligors. The receivables include installment payments from the loan obligor and the reimbursement of any unearned insurance premiums. Receivables, or the entire beneficial interest in such receivables, are transferred to the issuer, a bankruptcy remote special purpose vehicle (SPV). In a revolving structure, receivables are continuously transferred from the closing date through the end of the revolving period.

Generally, the seller/servicer makes an upfront, lump sum payment to the insurance carrier on behalf of each obligor and establishes a schedule for installment payments on the loan. The obligor repays the loan to the seller/servicer often times electronically via the Automated Clearing House (ACH) or credit card to ensure timely payment. Timely receipt of the installment payments on the loan is critical because the finance company receives unearned premiums from the insurance carrier based on the date the finance company cancels the policy. The finance company only cancels a policy once it is certain the obligor will not pay, but to protect itself typically does not allow more than 30-45 days to pass from the due date of the installment payment before canceling the policy.

**STRUCTURAL DIAGRAM:**





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## Operational Risk

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### ORIGINATION AND SERVICING REVIEW

The risk of loss in insurance premium finance transactions focuses primarily on the timely cancellation of policies in order to stop the insurer's earning of premium and for the remaining unearned premium to be rebated to the finance company. Accordingly, the quality of the servicer's operational capabilities are of paramount importance when rating a potential transaction.

DBRS conducts an operational review of the servicer to determine whether the quality of the systems and personnel are satisfactory to effectively manage the obligor and insurer relationships, track delinquencies, file cancellation notices in a timely fashion, and properly track rebates from the insurers.

As part of the review, DBRS assesses the origination process for the financing loans. Given that the policies being financed are pre-arranged through the insurance carriers, finance companies typically perform minimal underwriting. However, finance companies may maintain certain eligibility criteria for a financing loan to be made and/or included in a lending facility. Often these eligibility criteria relate to the obligor being sourced through an approved channel (e.g. agent, broker or insurer with whom the finance company has a business relationship) and accepting standard terms of the finance company's loan product. To be considered as eligible collateral for a transaction, the receivables may need to meet other criteria, including compliance with certain concentrations limits (e.g. insurers, insurers' ratings and geography).

Although the underwriting may be minimal, fraud protection is critical. DBRS expects sufficient protocols to be in place to minimize the opportunity for fraud, which could result in the policy being contested and a delay or refusal of the rebate of unearned premium.

Given that many insurance premium finance companies are not rated entities and conduct their own origination and servicing processes, a back-up servicer is often retained. DBRS expects the servicing of the portfolio to be backed-up on a regular basis and that a successful servicing transfer can be achieved in a timely and efficient manner in order to minimize any disruption in servicing if the primary servicer can not adequately perform these duties or is no longer financially viable.

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## Credit Support

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As explained in more detail below, credit enhancement on insurance premium finance transactions typically includes the subordination of lower or non-rated classes of notes, overcollateralization and reserve funds. DBRS evaluates the proposed credit enhancement levels and requested ratings for a transaction by analyzing the weighted average ratings of the insurance carriers and the finance company's historical loss performance statistics.

### SUBORDINATION

The main form of credit enhancement in insurance premium finance transactions is the subordination of lower or non-rated notes with the subordinated classes of notes maintaining a lower priority of payments in the flow of funds or waterfall. In many cases, the issuer creates multiple retained subordinate classes, using such classes exclusively as credit support.



## OVERCOLLATERLIZATION

In a revolving master trust structure, the investor interest in the master trust collateral is increased to include an overcollateralization (OC) amount. This amount is sometimes defined as a dollar amount or a fixed percentage of the net amount outstanding for the related series of notes. The OC can be dynamic and increased when certain concentration limits are breached. In a term securitization, the OC amount may be static, and therefore based on an assumed limitation of concentrations and other risk factors, in which new, eligible collateral may be added only if pre-set concentration limits are not breached.

The amount of OC may vary depending upon the composition of the collateral pool, but a minimum threshold amount is derived from historical loss rates for property and casualty insurance premium finance companies. Losses result from a failure of an insurer to rebate the unearned premium following an obligor default in payment on the financing loan. Historically, the recovery rate on such obligor defaults is between 97% to <99% due to the strength of the legal obligation of the insurers to rebate unearned premiums. The risks to recovery, which drive the net loss number below 100%, are primarily the timing of the cancellation notice being delivered to the insurer and the insurer becoming insolvent during that period of time. The following multiples are applied in determining a corresponding OC level:

Rating Category	Loss Coverage Multiple
AAA	5-6x
AA	4-5x
A	3-4x
BBB	2-3x
BB	1-2x
B	1x

## RESERVE FUND

Reserve funds are a typical form of credit enhancement and can be used in lieu of overcollateralization. Reserve funds are used to provide additional liquidity, as well as protect against exposures to the pool of obligors and/or the insurers from whom any unearned premium may be relied upon to be rebated. Generally, DBRS expects a reserve fund to be sized to protect against exposures to insurers that are unrated and rated lower than the requested transaction rating. In a revolving facility with dynamic credit enhancement derived from a borrowing base, the determination of the appropriate sizing of the reserve fund is considered in conjunction with the elements of the borrowing base since any reserve fund is typically excluded from the borrowing base calculation.

## EXCESS SPREAD

The insurance premium loan obligations, which collateralize a transaction, include an interest component payable by the obligor that exceeds the interest rate on the rated securities creating excess spread. As the amount of excess spread can vary over time, and be affected by tranching and transaction triggers, DBRS does not rely on excess spread as part of the credit enhancement calculation.

## CLAIMS PAYING ABILITY OF THE INSURERS

Generally, a pool of insurers includes a widely diversified group of rated and non-rated carriers. A typical collateral pool comprises over 100 different insurers represented amongst 20,000 or more insurance premium loans. Concentration limits are included in the transaction terms to promote stability with regards to the credit quality of the insurance carriers. For insurers rated below the desired rating of the transaction, DBRS may assume some number of these entities or some portion of the related obligations default as an alternative method of evaluating the proposed credit enhancement levels. DBRS considers recovery on the defaulted amounts based on the servicer's history and the ability of the servicer to seek recovery from the state guaranty funds. However, high concentrations of non-rated and below investment grade rated insurers may limit the rating of a transaction. In a revolving facility with a borrowing



base, the borrowing base may address various over-concentrations regarding the insurance carriers, and mitigate some of the risk associated with the rebate of the unearned premium.

### TRANSACTION TRIGGERS

Additionally, structural features may exist in the form of triggers that, once tripped, may rapidly amortize the securities in accordance with the class priority. This decreases outstanding principal, first on the senior classes of notes, to ensure that such classes benefit from the structural seniority in the transaction. These triggers often relate to excess spread and the average monthly payment rates which could signal portfolio deterioration.

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## Legal Framework

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### SECURED RIGHTS

DBRS criteria seeks to ensure that the proper legal steps have been taken to transfer all of an originator's rights and interest in the premium finance loans, or the entire beneficial interest therein, to the SPV and that the SPV has been granted a security interest in the loans. A Uniform Commercial Code (UCC) financing statement must be filed to perfect the granting of a security interest from originator/seller to the SPV, and further financing statements will be filed perfecting the subsequent grant of a security interest from the SPV to the indenture trustee. DBRS seeks assurance in a legal opinion provided by counsel for an originator/seller that all necessary filings against an originator/seller have been made, that all necessary steps have been taken and that no subsequent actions are required to protect the ownership interests of the SPV in the assets. The UCC does not govern the perfection of a security interest in unearned premiums. In the case of unearned premium, state and/or common law usually governs perfection. Such laws generally require notice to the applicable insurance carrier in the unearned premium recipient's name. In jurisdictions where such law does not address perfection, it is typical insurance industry practice to use this notification as a method of perfection. In the sale documentation, the sellers should represent that this notice has been delivered to the applicable insurance carrier and/or its agents for each policy in the collateral policy.

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