

RESEARCH

Customer Asset Protection Co.

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**RATING A+/Stable/-- (STRONG)**

An insurer rated 'A' has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

HOLDING COMPANY

Capco Holdings Inc.

GROUP MEMBERS

None

DOMICILE

Vermont

LICENSED

Vermont

Company Contact

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Major Rating Factors**Strengths:**

- Strong capitalization, sufficient to pay losses under various stress scenarios.
- Niche market position as a provider of excess securities account protection to leading broker/dealers.
- Very liquid and low-risk investment portfolio.
- High underwriting standard with zero expected loss ratio.

Weaknesses:

- Modest scope of operations with a single line of business concentration.
- Short operating history.
- Reliance on highly rated reinsurers for remotely possible extremely large losses.

Rationale

The insurer financial strength rating on Customer Asset Protection Co. (CAPCO) is based on the company's strong capitalization, niche competitive position serving many of the leading broker/dealers in the U.S. and U.K., high liquidity, low investment risk, and an underwriting standard intended to result in an expected zero loss ratio. Offsetting factors include the company's modest scope of operations, short operating history since December 2003, and reliance on highly rated reinsurers for remotely possible extremely large losses.

CAPCO provides excess securities account protection for 23 leading broker/dealers in the U.S. and U.K., and this is CAPCO's only insured risk. Based on the multiple and remote triggers that are necessary to generate a loss for CAPCO, the company's frequency of loss is expected to be exceedingly low. The small number of insured broker/dealers that could cause a material loss to CAPCO are highly rated by Standard & Poor's Ratings Services and would have to become insolvent and have massive losses to client assets before CAPCO would pay any claims.

CAPCO is strongly capitalized, and has the ability to pay significant losses if necessary. In addition to its own capital, CAPCO relies on other resources such as excess-of-loss reinsurance from reinsurers rated 'AA' or higher. CAPCO's total resources enable it to cover losses that are in excess of the highest modeled losses under various catastrophic stress scenarios.

The investment portfolio is invested almost entirely in U.S. Treasuries with maturities of three years or less. As a result, the risk of material loss to capital because of investment performance is low, and the liquidity of the portfolio is very high.

Excess securities account protection is valued by broker/dealers, as it provides assurance to their customers that their assets are safe and helps the broker/dealer retain and attract clients. The value of CAPCO's product enhances its competitive position in its niche.

CAPCO prepares U.S. GAAP financial statements, which are audited by Saslow Lufkin & Buggy LLP, an audit firm that specializes in the insurance industry. Although CAPCO's management maintains the confidentiality of its financial statements, Standard & Poor's has access to the financial statements and reviews them as part of the rating process.

Outlook

CAPCO is expected to earn a stable and modest return each year, with a zero loss ratio. Retained earnings should cause capital to increase gradually. Losses to CAPCO are possible but expected to be extremely rare, as multiple triggers would have to occur for CAPCO to sustain a loss. These triggers include the insolvency of an insured broker/dealer, losses to customer assets, and the depletion of other resources that would inure to CAPCO's benefit, such as fidelity bonds, support from the broker/dealer's parent company, and SIPC coverage. CAPCO's strong capitalization, reinsurance protection, and management by experienced risk managers are expected to continue.

Competitive Position: Value Of Excess SIPC To Broker/Dealers Gives CAPCO Secure Position In The Market

CAPCO is a captive insurer owned by the broker/dealers it insures, which are leading U.S. broker/dealers and a few of their U.K. affiliates. The group of insureds changes little from year to year. The only changes in 2005 were the loss of Legg Mason Wood Walker and JP Morgan Invest LLC, because these companies were sold to parent companies that do not participate in CAPCO. CAPCO exists to provide excess SIPC and similar forms of excess securities account protection to its owners, which is coverage in excess of amounts covered by the SIPC in the U.S. and in excess of similar coverage provided by the Financial Services Compensation Scheme (FSCS) in the U.K. In addition, CAPCO might provide "sweep account" coverage for customer cash deposited in bank affiliates of member companies (in cases where both bank and broker/dealer become insolvent and losses occur), though this product has not yet been offered.

SIPC is a form of insurance that protects the customers of broker/dealers if there are losses to their accounts, which would be triggered by the broker/dealer's insolvency and by large losses to customer accounts. Because of the regulatory oversight of the SEC and the self-regulatory organization (SRO) to

which it delegates some oversight (the NYSE), and because of the risk management practices and segregation of customer assets, the risk of loss is considered to be remote. In addition, if customer account losses occur, SIPC coverage is structured so that SIPC will cover all customer losses except when the aggregate loss of customer assets is extremely large. Coverage under the FSCS is similar. Such large losses could conceivably happen due to massive fraud or operational failure at the broker/dealer.

The value of CAPCO to its insured broker/dealers is significant, based on its value to the broker/dealers' marketing efforts, and to a lesser extent on risk transfer. By having an excess SIPC insurer, a broker/dealer can provide assurance to customers and prospects that their accounts have protection at more than the \$500,000 SIPC limit and \$100,000 cash sublimit.

CAPCO is expected to have a strong and sustainable competitive position. It has a modest level of competition from insurers such as Lloyd's and XL Capital Ltd., who sell coverage to broker/dealers other than CAPCO's owners. CAPCO was formed in 2003 to provide excess SIPC coverage at a time when several insurers withdrew from this market. Standard & Poor's believes CAPCO, as a captive, is well suited to serving its customers' needs because its interests are aligned with those of its customers and it has management from the broker/dealer industry who have a strong understanding of the underlying risk.

Prospective

CAPCO is expected to maintain a competitive advantage as the excess SIPC insurer within the realm of its market leading broker/dealer owners. The value of excess SIPC to broker/dealers gives this product a secure position in the market. Substitute products are not expected, because insurance protection is well understood and easy to explain to broker/dealer customers, whereas the security and ease of explaining other products is likely to be lower. The risk of losing business to competitors is low because CAPCO is sponsored by its customers, is meeting its customer needs, and has the competitive advantage of a captive, as noted previously.

Management And Corporate Strategy

Company management is very experienced in risk management for financial institutions and knows the broker/dealer industry well. Some of the management will be outsourced and will come from the lead reinsurer and from leading professional services firms to the insurance industry in the actuarial, accounting, and legal areas. The board of directors primarily consists of executives from the insured broker/dealers, and the underwriter will inform the board of all underwriting decisions. The lead reinsurer changed in 2005, and this highly rated reinsurer will underwrite the business in accordance with CAPCO's strict underwriting criteria. The lead reinsurer has expertise in financial guaranty and is well versed in the reinsurance needs of financial institutions. Alignment of interests with the underwriters is achieved by having a substantial portion of risk born by the underwriter via excess of loss reinsurance.

Operating Performance: Premiums Sufficient To Cover Reinsurance And Other Expenses

CAPCO has a short operating history with no claims going back to its formation in late 2003. Despite CAPCO's short history, there is a long record of more than 30 years of excess SIPC coverage being written with no claims by other market participants with comparable underwriting standards. CAPCO is expected to operate with the same zero loss ratio record and to earn a stable and modest profit every year, as premiums should be sufficient to cover reinsurance and other expenses. The thing that could reasonably cause a material loss would be a claim, which is considered a very remote possibility. Other than claims, the only significant uncertainty to CAPCO's expense structure is the cost of reinsurance, but it is expected that CAPCO would have the ability to raise its insurance premiums commensurately if necessary. Although CAPCO's ROE is expected to be modest in the low single digits, the real value of CAPCO to its owners is strategic and not tied to earnings.

Enterprise Risk Management

Operational risk at CAPCO and at the insured broker/dealers is the biggest risk to CAPCO. The risk at the broker/dealers is substantially mitigated by the risk management infrastructures and regulatory oversight by the NYSE and SEC. CAPCO's ERM is considered to be adequate, reflecting the limited scope of CAPCO's operations and the risk management experience of its employees and external consultants.

Investments And Liquidity: Risks Are Taken In Underwriting, Not Investment Portfolio

The investment portfolio is a strength to the rating, as it is invested in highly rated short-term paper, mostly obligations of the U.S. government. The risk of material loss to the portfolio is very low, and the low investment yield that can be expected from such a portfolio is not viewed negatively, as the company will not be dependent on investment income to meet its objectives or to maintain its financial strength.

In a normal environment, in which there are no claims, liquidity is expected to be strong. Operating cash inflows should be strong and predictable and more than sufficient to cover the company's minimal operating expenses.

In the rare event of a claim, liquidity needs to cover the loss will be high. The extremely liquid investment portfolio and on-going operating cash flow should be able to pay losses, even in some extremely remote and severe scenarios. The most important liquidity consideration is the ability to convert the entire investment portfolio to cash in a period of roughly three years without material realized losses, which is about how long a Securities Investor Protection Corp. (SIPC) liquidation with losses to client assets takes. The short duration of the portfolio is more than sufficient to achieve this.

Capitalization: Capital and Reinsurance Sufficient To Cover Low Probability Large Loss Events

CAPCO's capital adequacy is very strong and in excess of what is needed if no loss occurs, which is expected to be true with high probability. The most significant need for capital is to cover extremely remote large losses. Capital available to cover losses consists of CAPCO's surplus plus excess of loss reinsurance that covers a layer of loss that goes beyond CAPCO's probable maximum loss (PML). Although a specific probability can't be estimated for the PML loss, it is considered to be extremely remote because there are multiple loss triggers and multiple sources of capital to absorb loss before CAPCO pays its first dollar. The PML is based on the largest loss that could be generated by any one broker/dealer insolvency in which 20 basis points of aggregate client assets are lost—a very large dollar amount, given the large size of the insured broker/dealers. When the losses are modeled, most of the loss is absorbed by SIPC, and the excess is absorbed by CAPCO.

For a loss to occur, an insured broker/dealer must become insolvent and have losses to client assets. The probability of both of these events occurring is less than the probability of a broker/dealer becoming insolvent. Considering that the insured broker/dealers are mostly rated 'A' or higher (including all the companies that generate material losses in modeled stress scenarios), this would suggest a probability of loss to CAPCO that is lower than the probability that an 'A' rated company default. Because of the regulatory reporting requirements for broker/dealers and segregation of client assets, it is expected that most problems would be addressed before the loss of any client assets.

If a broker/dealer becomes financially troubled, there are multiple sources of capital to absorb a loss before CAPCO pays a claim. The broker/dealers' own capital, fidelity bonds, and parental indemnities for the benefit of CAPCO are the first lines of defense and come ahead of CAPCO. After these sources of capital are exhausted, SIPC has more than \$3 billion of resources to apply to losses, which consists of more than \$1 billion in capital at SIPC, \$1 billion in lines of credit from a consortium of banks, and \$1 billion of borrowing available from the U.S. Treasury.

Financial Flexibility

CAPCO's needs for additional capital is minimal because its initial capital and retained earnings should be sufficient to meet all its needs. If additional capital were needed for some reason, its owners are expected to have the ability to put in additional capital. CAPCO also has directors and officers coverage that would mitigate capital requirements if it were to somehow have losses from lawsuits tied to mismanagement. In addition, reinsurance is an important part of CAPCO's structure. The attractiveness of this kind of reinsurance is high, as demonstrated by the strong interest of highly rated reinsurers in providing this coverage. Thus, CAPCO should have the ability to obtain the reinsurance coverage it needs going forward.

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