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# **Best's** Methodology and Criteria

## Alternative Risk Transfer



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# Alternative Risk Transfer

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## Outline

- A. Market Overview
- B. Balance Sheet Strength
- C. Operating Performance
- D. Business Profile
- E. Enterprise Risk Management (ERM)

The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

## A. Market Overview

AM Best categorizes Alternative Risk Transfer (ART) vehicles into the following broad groupings: single-parent (and pure) captives, group captives, risk retention groups, self-insurance funds, and protected cell companies. Their unique characteristics are discussed in the following sections.

### Types of Captives

#### Single-Parent and Pure Captives

Single-parent captives are owned by one company or group (the parent). Pure captives are single-parent captives that accept only the risks of the owner (or owner-affiliates). Not all single-parent captives are pure captives; in some instances, a single-parent captive can accept business from third parties.

#### Group Captives

Group captives offer insurance to several or many unrelated policyholder owners and can take many forms. Some group captives dedicate themselves to a particular industry, while others choose to write in a limited geographic area, such as a single state. Group captives are the ART vehicle that most resembles a commercial insurer and have similar rating dynamics.

#### Risk Retention Groups (RRGs)

In the US, risk retention groups (RRGs) are governed under the Liability Risk Retention Act (LRRRA) and designed to provide liability insurance for a consortium with similar business interests. Under this federal statute, an RRG is (except as specifically designated by LRRRA) subject only to the regulatory



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authority of its domicile state, even if it is a multistate insurer. This has implications for the rating process when considering the treatment of substitute forms of capital, particularly qualifying letters of credit (LOCs) and New York Regulation 114 trusts.

### **Self-Insurance Funds**

Several US jurisdictions allow for self-insurance funds as an alternative form of insurance. By definition, these types of ART instruments can write selected coverages only for policyholder owners doing business in that particular area. These funds differ from commercial insurers primarily in two ways: They are subject to (1) joint and several liability for any claims and (2) governed under a specific charter whereby the surplus is composed wholly of subscribers' savings accounts. "Joint and several liability" stipulates that all of the subscribers' savings accounts and all of the policyholder owners' assets can be used to satisfy any claims.

### **Protected Cell Companies (PCCs)**

A protected cell company (PCC) is a highly complex and flexible structure that can be used in a variety of ways by multiple users and sponsors; it can hold any number or combination of insurance and financial operations, transactions, or instruments.

For the purposes of this criteria procedure, and in line with most jurisdictions, a PCC is the legal entity comprised of a core and one or more incorporated and unincorporated cells which have assets and liabilities separate and apart from the assets and liabilities of other cells.

Evaluating a PCC requires a clear understanding of the characteristics of the business in the PCC, and of the PCC's structure, domicile, and ability to manage the exposures of its sponsor.

An insured organization that establishes its own PCC and divides its risks into a number of protected cells (PCs) within the PCC will essentially be treated like a pure captive insurer for rating purposes.

In contrast, in the case of a PCC composed of an amalgamation or hybrid of unaffiliated protected cells, whose assets and liabilities are segregated and whose owners or co-owners are unaffiliated with the owner(s) of the PCC, each protected cell will be reviewed independently to ensure that the risks transferred to each cell are being managed and funded at the levels commensurate with the PCC. Although each cell is evaluated individually, this analysis is conducted in conjunction with the analysis of the PCC. It is from the analysis of each protected cell that the concept of the weakest link is applied. This concept stems from AM Best's view that all of the PCC's policyholder rights are to be deemed *pari passu* with each other. While the *pari passu* concept applies, it is important to note that AM Best's ratings only apply to the PCC. AM Best does not assign separate financial strength ratings to any individual cell.

Protected cell companies are unique and have been in existence for more than two decades and AM Best fully appreciates the nuances of the PCC business model, the economies of these structures, the purpose of segregated funds and the basis for establishing and forming protected cells. Segregated

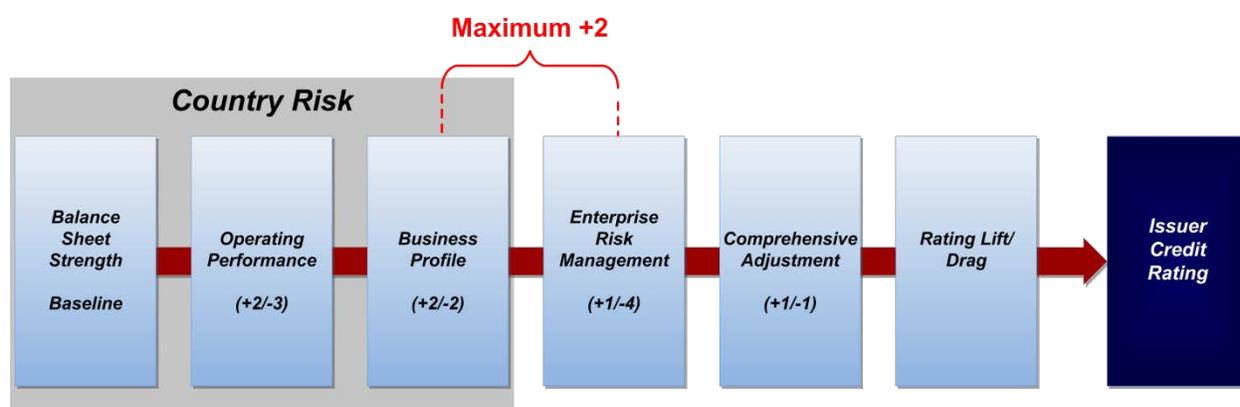
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cells have various legal structures, ranging from incorporated cells that have their own articles of incorporation and enter into contracts with other entities (including other incorporated cells) on their own paper, to protected cells that are not independently licensed and accept risk through internal financial transactions with the core cell. At present, AM Best only assigns its ratings to the PCC.

### The Rating Process

There are some key differences in the way that ART vehicles operate that affect the rating process and the building block assessments (outlined in **Exhibit A.1**). These considerations are discussed in the following sections, as are any instances in which the availability of the BCRM assessment descriptors (**Exhibit A.2**) differs from the process outlined in the BCRM.

**Exhibit A.1: AM Best's Rating Process**



**Exhibit A.2: BCRM Assessment Descriptors**

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

## B. Balance Sheet Strength

### Treatment of Letters of Credit

Letters of credit take many forms and typically are treated as debt in the rating process, whether for a commercial insurance carrier or for an ART entity (most often a single-parent captive). LOCs can be

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used to capitalize an ART entity, an arrangement encouraged by a number of captive insurance regulators, to help access an ART entity's capital if needed. As a result, an LOC may have more equity-like characteristics, which could result in equity credit for Best's Capital Adequacy Ratio (BCAR) purposes depending on the details of the LOC arrangements. LOCs eligible for consideration will adhere to most, if not all, of the following:

- Standalone
- Irrevocable
- Evergreen
- Funded
- Drawn on a highly rated bank

“Standalone” means that the instrument is not part of a credit facility or agreement that may contain covenants and terms that can impair the LOC's liquidity. “Evergreen” and “irrevocable” mean that the instrument automatically renews and cannot be canceled except by prior written agreement by all parties. “Drawn on a highly rated bank,” means that the LOC is to be funded with assets on deposit in a highly rated bank. This ensures that the bank takes the risk if the assets fall short of the face amount and that the credit risk of the bank does not cause an undue haircut of equity credit.

The LOCs that possess these elements may receive up to 100% capital credit, which may not be subject to the usual threshold of 20% of total available capital. Qualifying New York Regulation 114 trusts under similar conditions can receive capital credit as well.

### Net Retention to Surplus

An ART entity's balance sheet strength assessment can be adversely affected if the company writes a net aggregate per-occurrence limit greater than 10% of total available capital. This typically occurs when an ART entity provides large limits protection on high value properties or indemnity protection on high excess liability exposures. Such exposures may or may not be modelled. AM Best may use information it deems relevant to estimate potential large losses, such as the entity's full retained loss limit at all of the confidence levels in the BCAR model or by using some other metric (such as a probable maximum loss) which is viewed to be more appropriate when considering the particular risk(s) involved and the assumptions and data supporting the assessment.

### Loan-Backs to the Parent Company

Captives may want to make a loan of working capital to the parent organization for a number of reasons. In order to give these loans consideration in the rating analysis, AM Best expects that domicile-approved “loan-backs” will be documented properly with an arms-length loan agreement. The loan-back is then charged a risk factor that takes into account the risks associated with the loan, which may include a single large investment charge. The largest risk is generally the parent company's credit risk, which is assessed via external credit ratings (when available) and internal financial analyses.

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A loan-back may pose other risks—relating to the strength of the loan-back agreement and the parent company’s cash-flow volatility, for example—that may factor into the assessment. The relative aggregate size of the captive’s LOCs and loan-backs in relation to its total capital may also affect the assessment.

### Holding Company Assessment

A holding company impact review is not part of the balance sheet assessment process for lead rating units with non-insurance parents. Instead, the impact of the non-insurance ultimate parent is captured in the rating lift/drag assessment.

### Balance Sheet Strength Considerations for Different Types of ART Vehicles

#### RRGs

RRGs are distinct from other types of insurers in that only member insureds (policyholders) can be owners and only owners can contribute capital to the company. However, a sponsoring enterprise such as managing general agents (MGA) or third-party administrators (TPA) may form and administer an RRG but they cannot make direct capital contributions as they are not the owners of the RRG. Instead, these sponsors can provide a qualifying LOC or surplus note, which AM Best may consider giving available capital credit in BCAR if conditions warrant.

#### Self-Insurance Funds

AM Best generally gives full credit in BCAR to Subscribers’ Savings Accounts, depending on the specifics of the individual self-insurance fund.

#### PCCs

For those PCCs composed of a group of protected cells unaffiliated with the core PC, the balance sheet strength assessment includes an analysis of each cell’s segregated funds on an expected and stress scenario basis, and reviews of each cell’s financial flexibility and access to additional funding if needed. Financial flexibility and access to funding can take the form of contractual arrangements with the core PC or the cell owner itself.

AM Best considers the PCC to be only as strong as its weakest cell. Therefore, the onus is on the PCC to ensure that each of its segregated cells is adequately capitalized. Throughout the year, AM Best reviews available financials on rated PCCs and their individual cells. Assuming that the designated individual cells bear all of the risk placed in the PCC, the balance sheet strength analysis will focus on the individual cells and the likelihood of a cell eroding its capital and that of the PCC. The evaluation will examine each cell’s financial condition, risk profile, loss and incurred but not reported (IBNR) reserves, and the credit exposures it has accumulated. In addition, any contractual relationships with other protected cells and with the PCC will be reviewed thoroughly. Financial flexibility and the capital adequacy of each cell are critical factors in the analysis.

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AM Best reviews any contractual arrangements the PCC maintains with its member cells to determine how much, if any, financial flexibility the arrangements afford. These arrangements could take the form of capital maintenance guarantees, stop-loss agreements, or other similar arrangements with the PCs. The contracts need to be examined carefully to determine the extent of these liabilities, as well as any risk-sharing among the cells.

The link between individual protected cells and the PCC becomes increasingly important if the failure of a segregated cell has the potential to result in disruption for or financial stress to the PCC or to other cells within it. Thus, when establishing a protected cell, a PCC's ability to look to those segregated cells and their sponsors for the necessary support and funding is extremely important. The greatest risk in a PCC structure is not necessarily the risk that each individual protected cell poses to another; rather, it is the link between the segregated cell(s) and the PCC.

### C. Operating Performance

#### Capital Preservation and Operating Performance

The ART marketplace was born out of the capacity shortages and price volatility of the commercial insurance market that have historically resulted from the vagaries of the underwriting cycle. The mission of an ART vehicle is to provide consistent, tailored coverage at stable pricing to policyholder owners. Thus, these entities typically focus more on preserving capital rather than on generating returns for shareholders. Rated ART entities generally record solid profitability before policyholder and stockholder dividends. As a result, ART vehicles may appear to have lower levels of underwriting and net income available to common shareholders. Consideration is given within the operating performance assessment to return measures before and after dividends, depending on an ART's historical use of these dividends.

#### Volatility of Operating Results

Because a captive's risk is relatively narrow in scope, there tend to be periods of very low losses contrasted with periods of significant losses. What AM Best looks for in these cases is the parent company's history of demonstrated support or a documented support agreement that outlines the intent and ability to support the captive with economic resources if needed.

### D. Business Profile

In general, an ART entity would not receive a business profile assessment higher than "Neutral." However, AM Best does recognize the unique nature of the relationship between the ART entity and the insured, and its impact on business profile. ART vehicles can have customized coverages, customer-specific claims, and loss-control solutions, and owner insureds representatives on their boards.

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AM Best typically looks for signs of how well and to what degree the captive is entrenched in the parent's insurance risk management function and the ways in which the captive provides value. In other cases, the commercial activities of the captive might be used simply as a risk-financing tool.

### Business Profile Considerations for Different Types of ART Vehicles

#### **Group Captives and RRGs**

Insured renewals for group captives and RRGs tend to be much higher than for commercial insurers, averaging more than 90%. Group captives and RRGs gain and retain business by providing narrowly defined and very specific products to address specific needs. Historically, value-added services such as loss control and engineering, in addition to policyholder dividends, have enabled these ART vehicles to hold onto customers even in soft insurance cycles.

#### **PCCs**

Based on the variations in the legislative and regulatory provisions and enforcement mechanisms in different domiciles, the regulatory framework under which PCCs are established is a key component in the business profile assessment.

### **E. Enterprise Risk Management (ERM)**

AM Best will assess the risk management framework and profile/capability of the captive, relative to the parent company's business operations.

### ERM Considerations for Different Types of ART Vehicles

#### **Group Captives and RRGs**

The ERM assessment for group captives and RRGs is similar to that of a commercial writer, and focuses on the captive's risk management framework and risk profile relative to its capabilities.

#### **PCCs**

Control and monitoring of any PCC program are crucial, to ensure that the expectations for response to claim incidents will be met, given the capabilities and limitations of individual cells; measures taken to address these concerns should be evident in the PCC's ERM framework processes.

Other important risk considerations include the type of PC used—whether open or closed to new business, or some variation in between—as well as the contractual relationships among the cells in the program, and between them and the PCC. Fronting and reinsurance agreements are also examined in detail to determine whether the protected cell program will be adversely affected by the provisions in those agreements.

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