Alternative Risk Transfer

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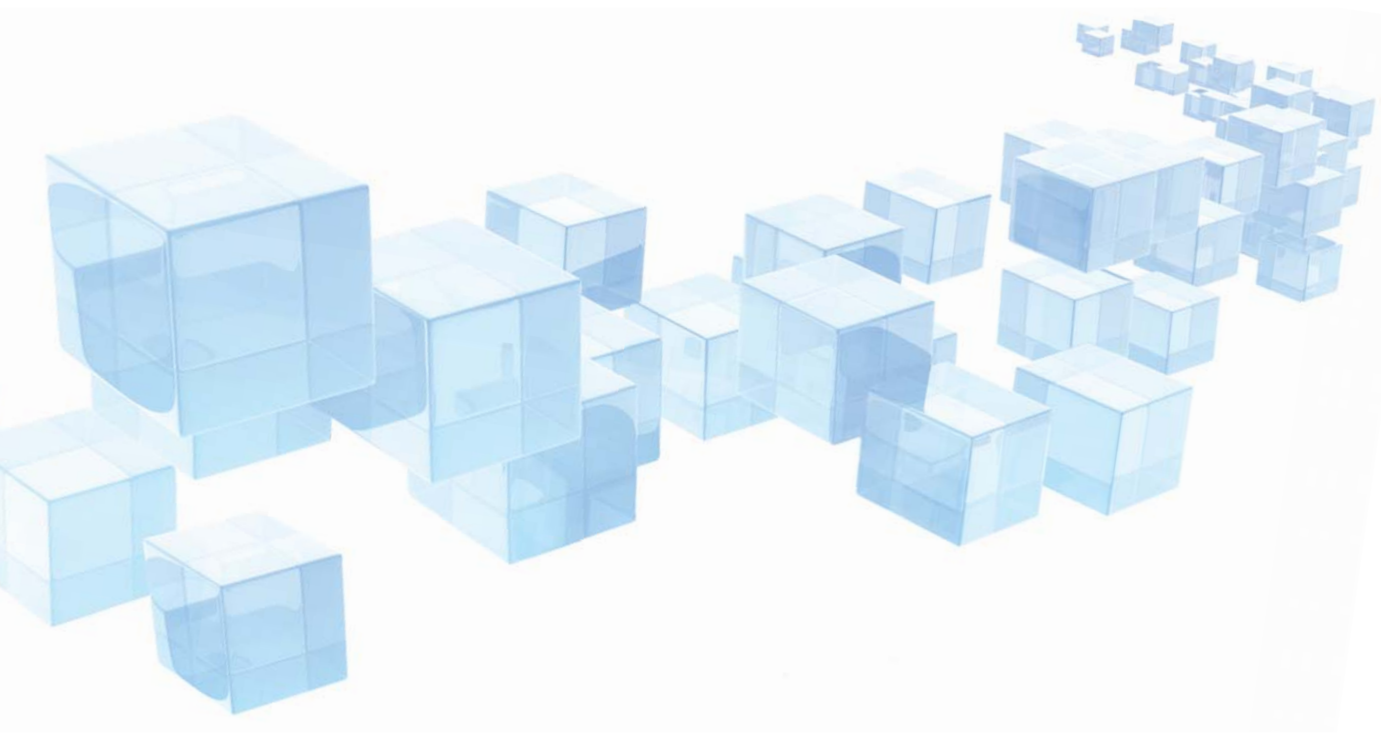

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Outline

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 A.M. Best Rating Services' rating process.

A. Market Overview

Generally, alternative risk transfer (ART) vehicles emphasize capital preservation over operating performance and place greater weight on business retention over market share. A.M. Best categorizes 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 U.S., risk retention groups (RRGs) are governed under the Liability Risk Retention Act (LRRA) 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 LRRA) subject only to the regulatory 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 U.S. 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.

Evaluating a PCC

Evaluating a PCC or core PC (protected cell) 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 PCs within the PCC will essentially be treated like a pure captive insurer for rating purposes. Also, a cell with the financial flexibility to access additional funding from its sponsor would be treated similarly to a pure captive operation and can be rated in a comparable fashion.

In contrast, in the case of a PCC composed of an amalgamation or hybrid of protected cells unaffiliated with the core PC, each protected cell must be reviewed independently to ensure that the risks transferred to each cell are being managed and funded at the levels commensurate with the PCC. Thus, a PCC's rating does not extend to the individual PCs within the PCC's structure. Although each cell is evaluated individually, A.M. Best issues ratings on only the core PC. A.M. Best understands the PCC business model, the basis for establishing and forming protected cells, and the PCC's unique structure of independently owned (or funded) entities. However, the core PC is still viewed as the policy-issuing company; the concept of the weakest link is applied, which views all the PCC's policyholder rights as *pari passu* with those of the policyholders the core PC insures.

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: A.M. Best's Rating Process

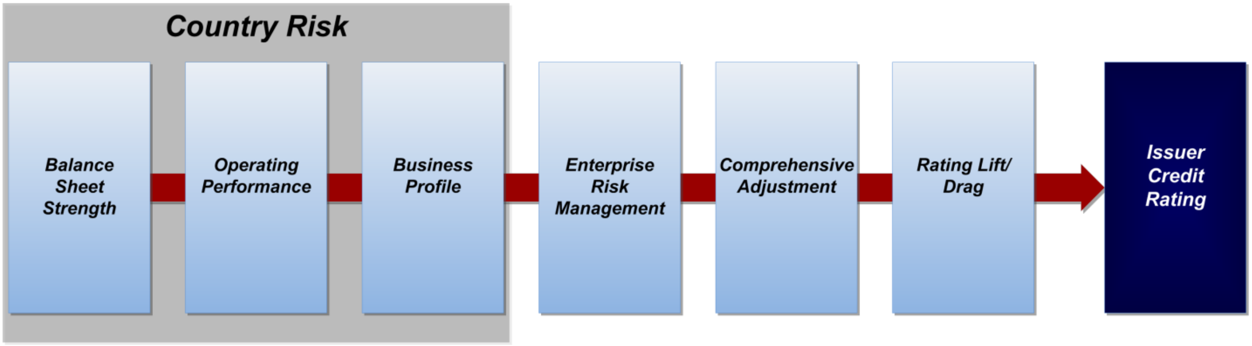

Exhibit A.2: BCRM Assessment Descriptors

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 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. The details of the LOC must be presented to A.M. Best for capital consideration. To be eligible for consideration, the LOC must be 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 should 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 meet these requirements may receive up to 100% capital credit which may not be subject to the usual threshold of 20% of surplus. Qualifying New York Regulation 114 trusts under similar conditions can receive capital credit as well.

Net Retention to Surplus

Similarly to all commercial writers, 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 surplus. To assess the ART's ability to withstand such a loss, A.M. Best will use the full retained loss at all of the confidence levels in the BCAR model.

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. These domicile-approved "loan-backs" must 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. 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.

Balance Sheet Strength Considerations of Different Types of ARTs

RRGs

RRGs are distinct from other types of insurers in that only owners can contribute capital to the group, and only policyholders can be owners. So a managing general agent (MGA) or third-party administrator (TPA) that runs a program using an RRG to write the liability insurance cannot make a capital contribution to the organization; what it can do to bolster capital is sponsor a qualifying LOC. After conducting a detailed analysis of the sponsor's long-range intentions, A.M. Best can consider giving available capital credit in BCAR in these situations if conditions warrant.

Self-Insurance Funds

A.M. 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.

A.M. Best considers the PCC to be only as strong as its weakest cell. Therefore, the onus is on the core PC to ensure that each of its segregated cells is adequately capitalized. A.M. Best reviews quarterly 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 core PC will be reviewed thoroughly. Financial flexibility and the capital adequacy of each cell are critical factors in the analysis.

A.M. Best reviews any contractual arrangements the core PC 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 core PC becomes increasingly important if the failure of a segregated cell has the potential to result in disruption for or financial stress to the core PC and/or other cells in the PCC. Thus, when accepting 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 profits or returns. 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 A.M. 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." Most ART entities have a limited market share and therefore a limited business profile compared with many commercial insurers. However, A.M. 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.

A.M. Best looks for signs of how well the captive is entrenched in the parent's enterprise risk management and commercial activities, on a continuum that ranges from the captive being used simply as a risk financing tool, to its being used as the platform from which the parent company's enterprise risk management program is implemented.

Business Profile Considerations of Different Types of ARTs

Group Captives and RRGs

Insured renewals for group captives and RRGs tend to be much higher than those of 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

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

E. Enterprise Risk Management (ERM)

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

ERM Considerations of Different Types of ARTs

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 the cell captive;

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, closed, or some variation in between—as well as the contractual relationships among the cells in the program, and between them and the core. 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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