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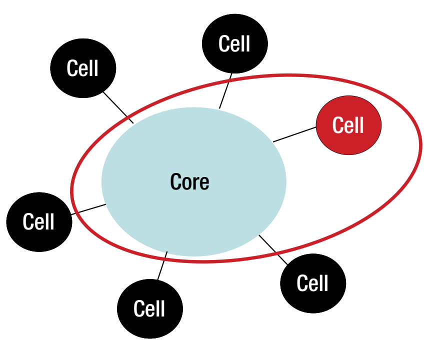
Rating Protected Cell Companies

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

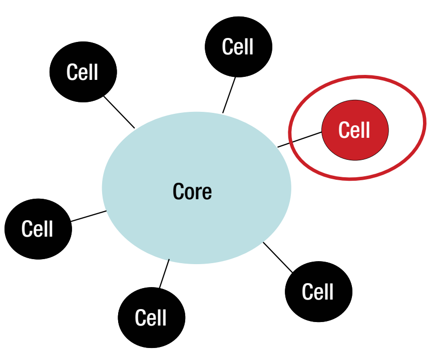
Evaluating the financial strength of a protected cell or protected cell company requires a clear understanding of the characteristics of the business that is placed in a PCC, the structure of the PCC, the domicile and the program's ability to handle the exposures of its sponsoring organization. If the insured organization establishes its own PCC and subdivides its risks into a number of protected cells (PCs) within the PCC, then for all practical purposes it will be treated like a pure captive insurer for rating purposes. Also, if a cell has financial flexibility to access additional funding from its sponsoring organization, this option would be treated on terms equivalent with that of a pure captive operation and can be rated in a comparable fashion.

On the other hand, if an organization places its risks into protected cells that either have no access to additional funding and/or are under the umbrella of another entity's PCC, or core, then that PC must be reviewed carefully to ensure that the anticipated protection will exist should it be needed. It is important to know the quantity of risk transferred to the cell, based on both expected and worst-case scenarios. The generally smaller size and limited scope of individual PCs make stress testing for various adverse scenarios more important, particularly if financial flexibility is limited. Nonetheless, due to the flexibility allowed in the contractual arrangements in establishing a PC, mechanisms can be incorporated to allow for various means to either fund the cell adequately up front for all reasonable circumstances, or to have access to on-demand additional funding from the PCC or from the owner of the cell.

Ringfencing in Protected Cell Companies



In some jurisdictions and certain cell company configurations, creditors can claim against the core.



In other jurisdictions, assets of the cell are ringfenced from both the core and other cells.

Information Needed To Rate a Protected Cell Captive

The information needed will vary based on the particular business/issue placed in the PCC. However, most PCCs would have to provide at least the following information:

1) Audited financials for the PCC and each cell
2) Actuarial reports
3) Contractual agreements between cells
4) Collateral agreements
5) Reinsurance agreements
6) Cell sponsor/user information

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The analytical team will examine the PC's financial condition, its risk profile, its actuarially determined loss and IBNR reserves, and the credit exposures it has accumulated. In addition, its contractual relationships with other protected cells, if any, and with the core PCC will be reviewed thoroughly. Financial flexibility and the adequacy of the PC's capital relative to the risks assumed are the critical factors in this analysis. Assuming that designated, individual protected cells exclusively bear all the risks placed with a PCC organization, and that the PCC core does not take any of these underwriting risks, then the analysis will focus on the likelihood of the PCC's own capital base being eroded from any contractual relationships it has with the member PCs. This could take the form of capital maintenance guarantees, stop-loss agreements or similar arrangements with the PCs. Here too, the contracts need to be examined carefully to determine the extent of these liabilities, as well as the potential for attachment of funds by a regulator or a court of law in the case of any member PC becoming insolvent. In these cases, a financial evaluation of all PCs, which could have a potential material impact on the PCC, needs to be conducted, regardless of whether those PCs are rated individually or not, and the aggregate exposure to the PCC must be compared with the PCC's resources to respond to those needs. A financial strength rating on a PCC does not automatically extend to the individual PCs within the protected cell company structure.

The preponderance of legal opinion on the legislation, however, comes in on the side of the protected nature of each cell. Lingering issues remain that could have an impact on the protected cell movement. These include tax liability matters; insolvencies of sponsoring companies; and run-off situations.

Control and monitoring of any protected cell captive program is crucial to ensure that the expectations for response to claim incidents will be met, given the capabilities and limitations of the cell captive. There are certain overriding themes and issues that will have an impact on the utility of such a program for the insured and on the financial strength associated with it. Fronting and reinsurance agreements will be examined in detail to determine whether the protected cell program will be impacted adversely by the provisions contained in those agreements. Other important considerations include the type of protected cell that is employed, whether open, closed or some variation in between; the contractual relationships among the cells in the program and between them and the core; and the ability of each cell to absorb shock losses or adverse development. Finally, as all domiciles offering venues for protected cells have some variations among their enabling legislative and regulatory provisions and their enforcement mechanisms, the regulatory framework under which the protected cell company and the PCs are established will be evaluated and monitored.

From RACs to SACs

There are a variety of terms used in reference to protected cell companies and similar structures. With more than 30 different domiciles having promulgated PCC legislation and with the differences among the laws, the multiplicity of terms is not surprising. In addition, the protected cell company may be viewed simply as a variation of the rent-a-captive structure or even a special-purpose vehicle. There also are several other legal structures that have similarities to the PCC. Hence, the multitude of terms, structures and perspectives may cause confusion, even for the experienced ART practitioner. Below are some of the terms and acronyms used:

PCC Structures:

The following list of names and acronyms includes examples of the terminology utilized by various domiciles to refer to actual PCCs.

Incorporated Cell Captive (ICC) (e.g., used in Jersey)

Protected Cell Company (PCC) (e.g., used in many U.S. state domiciles)

Segregated Accounts Company (SAC) (e.g., used in Bermuda)

Segregated Portfolio Company (SPC) (e.g., used in Cayman)

Sponsored Captive Insurance Company (SCIC) (e.g., used in Vermont)

Other Structures:

Producer Owned Reinsurance Company (PORC) – Captive reinsurance entity established to provide reinsurance for a producer's business.

Rent-a-Captive (RAC) – (Re)insurance entity that rents its capital, surplus and license to clients and provides administrative services. Clients' business is separated by accounting and contractual means.

Special-Purpose Vehicle (SPV) – Corporate entity created to enable a specific business transaction and fulfill a narrow objective.

Special-Purpose Financial Captive (SPFC) – Corporate entity created for the securitization of insurance risk. It may establish protected cells.

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