Rating Reinsurance Pools

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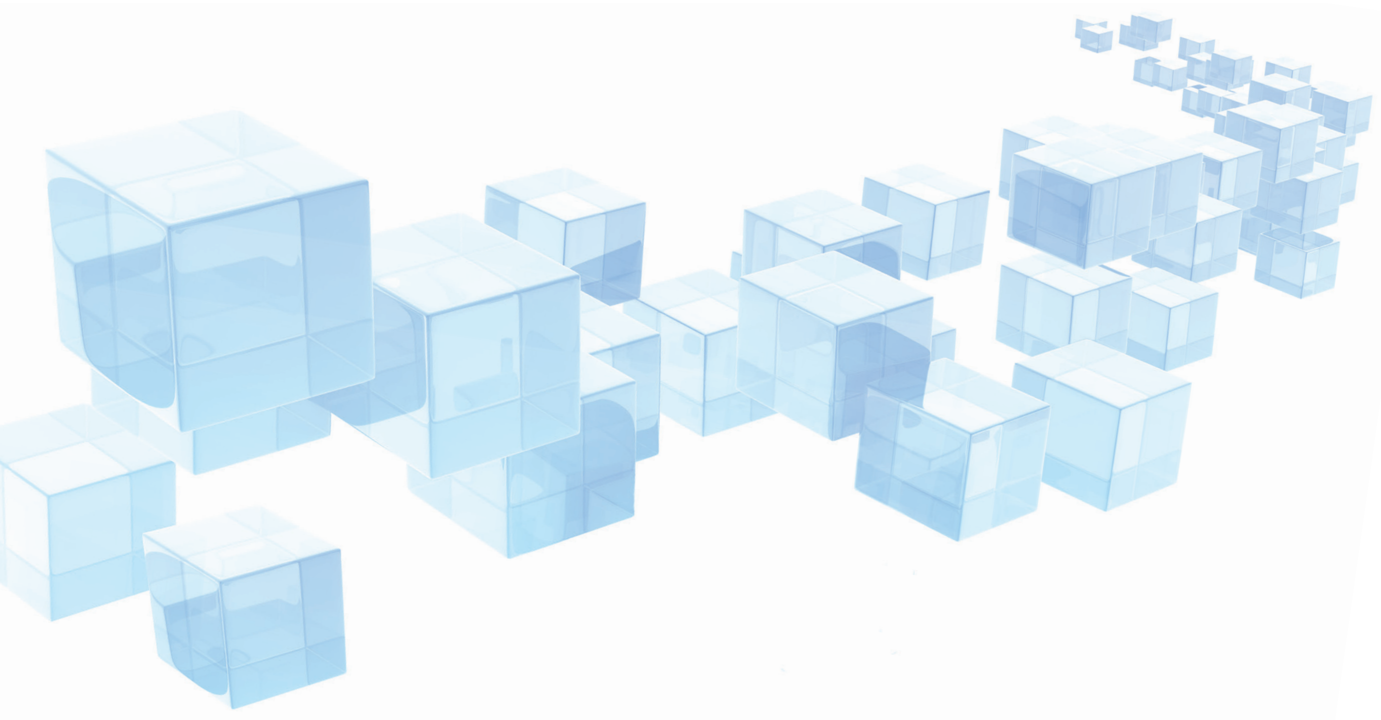

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Outline

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

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.

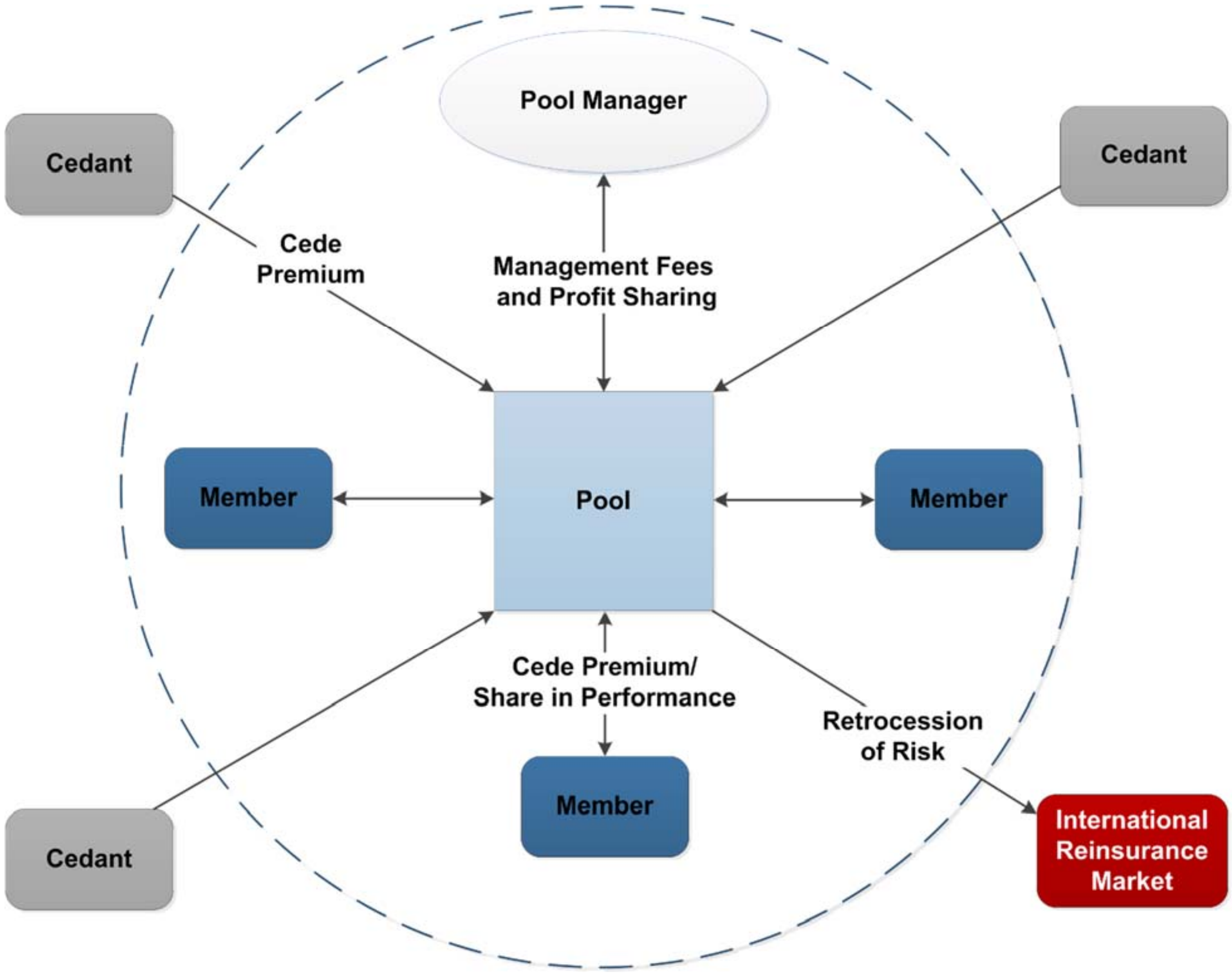
A. Market Overview

The international reinsurance market is the primary mechanism for the transfer of insurance risk. However, the availability of adequate reinsurance protection in some markets is limited, particularly for high-value natural catastrophe and terrorism risks, which have given rise to national and regional reinsurance pools. Though comprising only a fraction of the reinsurance market, pooling arrangements have been active since at least the 1950s and are likely to play an important role for risk transfer and risk mitigation in both developed and emerging markets. Reinsurance pools demonstrate the need for unique risk transfer, providing an alternative solution to traditional reinsurance. While some pools are private and independently run operations, in many cases, pools exist through government requirements to provide adequate cover to markets, particularly pertaining to high-severity risks. As such, pools can be government-owned or have an element of government sponsorship.

There are many structures and arrangements commonly referred to as reinsurance pools; however, A.M. Best defines a "reinsurance pool" as any entity that provides a mechanism for collective acceptance and sharing, equal or otherwise, of insurance risk among its members. (Note: The evaluation of the Lloyd's market falls under a separate criteria procedure due to its capital structure, its status as a market comprised of competing businesses with separate underwriting policies, and the fact that ratings can be assigned to its individual syndicates.)

This criteria procedure outlines the key considerations specific to reinsurance pools, and includes a discussion of how these distinctive features are treated in a rating evaluation. Given that the capital structures of reinsurance pools can vary greatly, they require particular attention when conducting an assessment of capital adequacy. Within the rating process there will be a greater focus on the corporate governance framework and level of financial support and commitment the members provide to the pool.

Exhibit A.1: Basic Structure of a Reinsurance Pool



Rationale for Establishing Reinsurance Pools

Insurers sometimes lack the expertise or capacity to underwrite or retain complex or high-value risks, such as natural catastrophes, energy, nuclear, aviation, war, and terrorism. This is particularly the case in emerging economies, where insurance markets are immature. Pooling high-severity exposures can provide a suitable mechanism for risk transfer or risk sharing. Compulsory schemes for catastrophe management and terrorism cover in many jurisdictions have emerged to ensure adequate protection to policyholders and governments.

For catastrophe reinsurance, in many cases there may be a ceiling or limit on the allowable exposure to reinsurers, as well as exclusions in instances such as terrorism and war. However, while demand for insurance cover of such risks remains, capacity can be volatile, often falling short and leading to inefficient markets. Given the size and type of risks usually covered and the potential economic impact on a country or region, pools often have some level of government involvement. In many emerging markets, natural catastrophe pools have been created and receive compulsory cessions, which limit to a certain degree the adverse impact that governments may have to absorb directly post-disaster in the absence of insurance cover.

Indeed, the business mix of most direct writers within emerging economies tends, on a net basis, to be highly skewed toward short-tailed motor and medical lines, with commercial risks such as energy, fire, and engineering business largely fronted for the international reinsurance market. In these markets, pools generally are used as a mechanism to retain risks within the country or region. Cedants utilize the pool to reduce their exposure to high-severity risks, which would add unwanted volatility if retained. For the members, the pooling of risks adds diversification across classes of business and territories, which they otherwise would be unable to achieve. The cedant may receive inward commission from the pool for the successful placement of good-quality risks. This can provide the members with improved risk selection and diversification, thereby allowing greater purchasing power in international retrocession markets. For the pool to achieve its desired effect, all parties must trust in the pool's risk-transfer and risk-sharing mechanisms. As such, it is essential for the pool manager to build a strong corporate governance framework.

Structure of Reinsurance Pools

Reinsurance pools can be structured and governed in different ways. There are pools that are incorporated companies, licensed and registered within a jurisdiction and subject to local regulatory requirements, which operate in a similar manner to that of a reinsurance company. Conversely, there are pools known as policy-issuing entities that may have no hard capital commitments and are based on the principle of reciprocal reinsurance, as outlined in a contractual agreement among members, the pool manager, and its cedants. Lack of clarity in the organizational structure (e.g. ambiguous definition regarding the structure of the reinsurance pool and/or absence of material tangible capital), is considered as a negative within the rating assessment.

Often, pools are set up through a special decree/statute or under specific provisions of local laws. Therefore, in certain cases, they may be exempted from the regulation to which conventional (re)insurers are subject. This places additional emphasis on strong corporate governance and self-imposed discipline.

A.M. Best evaluates the capital structure and composition of each individual pool to understand the commitment of members' participation and the corporate governance mechanism in place to assess the reinsurance pool's capital strength.

Common Pool Stakeholders

Within each pool there are some common stakeholders. A.M. Best defines the key stakeholders as follows:

Pool Manager

The pool manager is considered an essential stakeholder, given that it is responsible for the governance of the pool. Such duties may include, but are not limited to:

- Dealing with members and providing all the necessary back-office functions, including a system of internal control
- Managing the pool's cash flow and capital requirements where applicable
- Setting underwriting guidelines
- Setting parameters for risk tolerance, limits, concentration, and accumulations
- Purchasing retrocession cover
- Enforcing guidelines for minimum selection requirements for cedants and members
- Establishing and managing the corporate governance framework (risk committees, pool participation levels, and voting rights)
- Establishing mechanisms for commission payments, profit distribution, and recoveries for underwriting deficits
- Managing pool functionality and addressing key issues
- Creating and implementing the risk management framework

The pool manager is typically a member of the pool and often the founder. The pool manager usually receives a management fee in addition to profit-sharing arrangements through its position as a member. The pool manager's role is akin to that of a managing general underwriter. In some instances, the pool manager may not be a reinsurer or insurer and may undertake no liabilities of the pool.

Members
The members of a pool are those companies that enter a reciprocal agreement with other pool members and can cede business into the pool while also accepting retrocession from it. The members could be liable to cover all claims costs and other associated liabilities arising from the pool—which may be subject to individual limits—but they will benefit from any profit distribution generated by the pool. Members must adhere to the terms and conditions established by the pool's articles of association to maintain their membership within the pool.

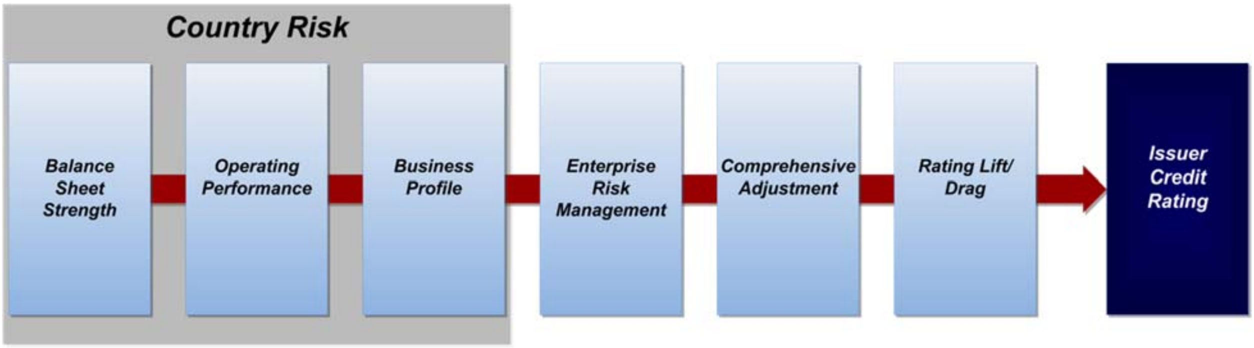
Cedants
A cedant is an entity that cedes business to a pool but does not accept a share of retrocession.

International Reinsurance Market
The pool may actively utilize retrocession markets to reduce volatility in its profile, particularly if it is exposed to high-severity risks or operates in catastrophe-prone regions. The pooling of risks should provide greater diversification and capacity, which in turn enables greater negotiating power with retrocessionaires.

A.M. Best's Rating Process

A.M. Best reviews key rating factors or building blocks—namely balance sheet strength, operating performance, business profile, and enterprise risk management (ERM)—when assigning a rating to an insurer (**Exhibit A.2**). This criteria procedure focuses on the considerations specific to reinsurance pools as they relate to these key rating factors.

Exhibit A.2: A.M. Best's Rating Process



B. Balance Sheet Strength

The Pool's Capital Structure

The strategic objective and diversity of reinsurance pools have led to many different formations and structures. As such, the capital structure can vary considerably from one pool to the next. Some reinsurance pools have no hard capital committed but instead rely on the option to make capital calls from their members if the need arises. The assessment of these pool structures will be based largely on the financial strength of the pool members, the strength of the corporate governance framework, and the members' commitment to the pool. A.M. Best's view on members' commitment will focus on enforceability and historic precedents in relation to specific situations (e.g. instances where capital calls may have taken place or members' shares have been redeemed). Given the unique structure of pools, the credit quality of the pool members will be assessed. To provide a rating assessment on a pool, A.M. Best expects to have ratings coverage on a strong majority of its members. Consideration also will be given for the participation of insurance companies within the pool and their respective expertise.

Measuring Capital Adequacy

A.M. Best assesses whether or not the pool has sufficient assets held in trust or callable letters of credit or other contingent capital instruments to ensure the pool can meet its financial obligations. A.M. Best assesses the strength of the capital commitments and considers credit in its capital model (Best's Capital Adequacy Ratio). Consideration also will be given for the level of financial flexibility and fungibility of capital between pool members, as well as any clauses for recapitalization of funds in the event they are exhausted. If necessary, A.M. Best may seek an independent legal opinion on the pool, particularly pertaining to the enforceability of the contract between the pool and its members.

Depending on the pool's capital structure, A.M. Best may measure capital adequacy based on the estimated unexpected loss amount (i.e. deviations from expected losses at a certain confidence level) of the pool's net exposure. The unexpected loss amount may be tempered by any guarantees by pool members or average ratings of the pool members. For these alternative capital structures, the probability of exhausting the capital and surplus will be one of the factors reviewed when determining the rating. A level of capital to address unexpected losses is essential for these pools because of the following reasons:

1. The unexpected loss amount, which is essentially the net capital and surplus position, is part of the quantitative aspect and a key ingredient in assessing the financial strength and creditworthiness of insurance entities.
2. The membership of a given reinsurance pool may be made of heterogeneous entities with varied interests and objectives. For example, pool membership may not be restricted to reinsurers and insurers, but may include hedge funds, insurance-linked securities specialists, etc. These entities with diverse opinions may impact the viability of the pool, despite all the legal and corporate governance documents. Furthermore, some of these entities in the pool may not be rated by A.M. Best, making it difficult to assign the tail risk back to the pool members. In such cases, an appropriate level of capitalization is needed to cover the pool's insurance and other contractual obligations.
3. Reliance on the ratings of pool members may not always suffice. Further, the entering and exiting of pool members may exacerbate this issue. Thus, although qualitatively, the average ratings, contract clauses, and additional financial flexibility, including guarantees, may be used to temper capital requirements, an estimate of the unexpected loss amount for each member is critical to assessing balance sheet strength of the pool. The difficulty associated with the duration/unwinding of these pools is always a concern.

The conditions binding the liabilities of the pool to its members are key. Pools generally operate in contract cycles (such as one- or three-year commitment periods), after which membership of the pool can change. A.M. Best would review the notice period required before any party (the member or the pool manager) relinquishes ties with the pool. Another important factor is the run-off of liabilities after the end of the contract cycle. A.M. Best needs to understand the consequences surrounding any member that exits the pool and the departing member's participation in any liabilities that may arise in the future. If the pool allows special circumstances in which a member can leave the agreement early, then A.M. Best will review the obligations of the remaining members to cover any outstanding liability. Stability in the composition of members is considered a positive rating factor. Given that typically there is no central fund to access in case of extreme losses, A.M. Best will assess the mechanism in place to support the pool's continuity.

Financial Distress

Pool members need to carefully consider the implications if the pool faces financial distress. Clear policies and rules defined in the pool's charter should outline the mechanism in place for a distressed scenario, as well as members' commitment to the pool. Moreover, A.M. Best will also need to understand the implications should the pool's manager run into financial difficulty. In such instances, A.M. Best will assess the conditions under which the pool manager's role can be transferred to another member or a third party. Where the pool's manager acts as cedant and/or member, there may be multiple issues that would need to be governed adequately to ensure sufficient protection for the pool. The pool should be transparent and maintain sufficient funds committed from members to cover such adverse scenarios.

Reserve Adequacy

Given the limited contract cycle of pools, A.M. Best will assess that sufficient reserves are held until all liabilities have been run off from the operation. This highlights the importance of regularly monitoring reserves and maintaining them at an appropriate level to reduce the possibility of a shortfall. Therefore, A.M. Best will assess the mechanism in place for distributing underwriting surpluses, taking into consideration reserve adequacy and any potential recourse from members to cover adverse loss-reserve development. Furthermore, it is important for a pool to demonstrate that it has sufficient funds to cover a possible surge in claims payments.

Probable Maximum Loss (PML) Exposure

The risks underwritten by the pool are, in many cases, associated with high-severity risks. A.M. Best conducts stress tests to assess the pool's capital strength under adverse scenarios. The tests will determine whether the pool has sufficient funds or commitments to support the operation prospectively in a catastrophe-stressed environment. Moreover, in such a stressed environment, A.M. Best will assess any further strain on the pool, given that there may be correlation between the pool and its members' assumed risks.

C. Operating Performance

The operating performance of a pool is restricted largely to its underwriting activities, as limited surplus funds are available for investment activity, particularly for those that have no hard capital committed. Hence, the pool's ability to generate a strong track record of technical profitability, which is likely to be comparable to that of a typical reinsurer, is emphasized in the assessment.

D. Business Profile

A.M. Best acknowledges that pool profiles can vary considerably. While some pools operate similarly to standard reinsurance companies, many function in niche markets, specializing in particular segments. For these pools, the assessments of product/geographic concentration and product risk may be more negative. The core principles underlying a pool's fundamental profile will be considered in the assessment and credit given to specialized pools that demonstrate their expertise in the market. The review of market position and distribution channels within the business profile assessment is not applicable to reinsurance pools.

In regards to the management quality review, A.M. Best will examine whether or not the pool manager demonstrates sufficient knowledge and expertise to run the pool effectively, in line with the pool's core principles as set out in its governance framework. The rating analysis emphasizes the pool manager's ability to manage the pool effectively to meet the members' strategic targets.

E. Enterprise Risk Management (ERM) and Corporate Governance

Enterprise risk management and corporate governance play pivotal roles when assessing reinsurance pools. A favorable factor would be a strong system of corporate governance, with a clear identification of the contractual agreement covering members, cedants, and the pool's manager. The level of transparency in the pool's operations is also key.

Additionally, should the pool manager be a member of the pool, A.M. Best will assess the extent to which conflicts of interest are managed. Such transparency might include the production of annual reports by a reputable audit firm with detailed footnote disclosures; third-party actuarial assessments of reserves; regular and meaningful risk committee reports; board of directors' reports; guidelines on member participation; and an independent legal opinion on the pool's liabilities.

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METHODOLOGY

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