

June 26, 2024

Best's Methodology and Criteria

Rating Sidecars



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Our Insight, Your Advantage™

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Outline

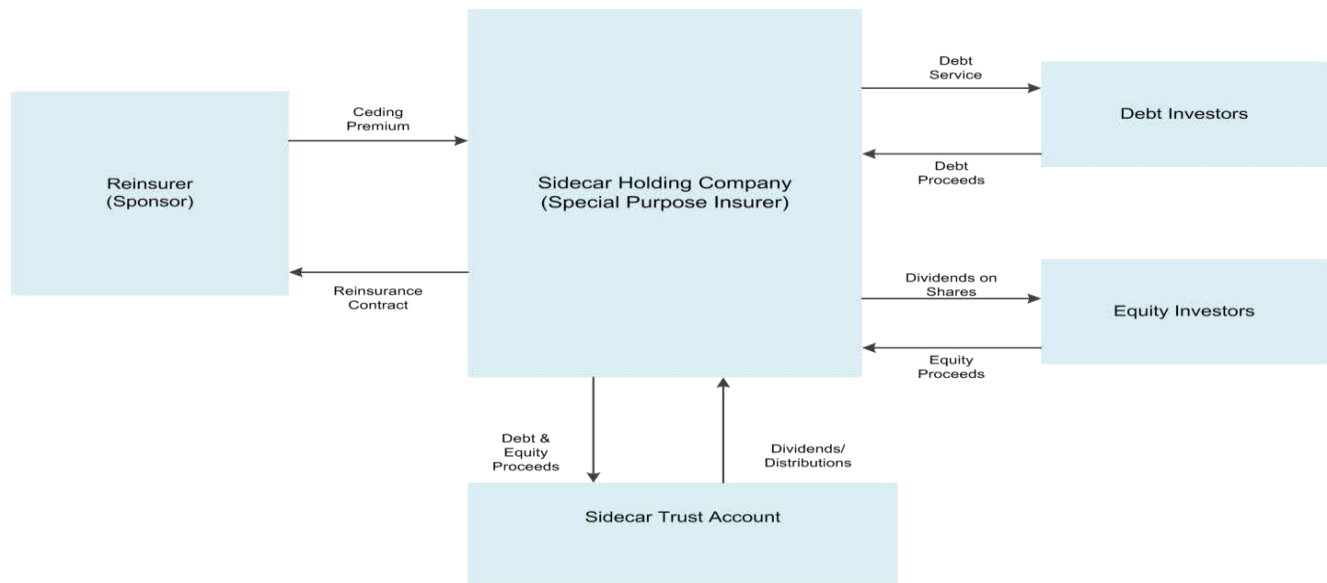
- A. Market Overview
- B. Rating Considerations
- C. The Assignment of a Rating

The following criteria procedure should be read in conjunction with *Best's Insurance-Linked Securities & Structures Methodology (BILSM)* and all other related BILSM-associated criteria procedures. The BILSM provides a comprehensive explanation of AM Best's rating process for insurance-linked securities and insurance-linked structures.

A. Market Overview

Sidecars offer a mechanism to transfer risk to investors and are an attractive alternative to traditional retrocession during periods of reinsurance market disruptions that result from major catastrophic losses, erosion of reinsurance capital and/or the escalation in reinsurance rates on line. A sidecar is a limited-life, special-purpose entity that generally provides property catastrophe quota-share reinsurance exclusively to its sponsor. Sidecars provide a way to offer rated debt to investors seeking exposure to various layers of catastrophic risks. This criteria procedure describes how AM Best assigns ratings to property and casualty sidecars.

Exhibit A.1: Sidecar Diagram



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AM Best evaluates the capacity and creditworthiness of sidecars to determine, in general, whether sidecars will strengthen, weaken, or have no effect on the financial strength ratings of the sponsoring reinsurers. The analysis focuses on the structural integrity of the transactions and the analytical rigor applied by various experts and advisers, such as peril modelers and investment banks. AM Best publishes Issuer Credit Ratings (ICR) and/or Issue Credit Ratings (IR), where appropriate, on sidecars and their corresponding debt (if any).

B. Rating Considerations

In general, this criteria procedure considers the risk characteristics of the underlying perils covered (as reflected in attachment probabilities) the financial models used and its output, and the results of stresses by AM Best on key modeling parameters. Some of the items reviewed, evaluated, or monitored include the following:

- *Data Quality*: The level of data quality is critical to the evaluation of the sidecar, as such, if data quality is deemed to be in question, the stresses in the analysis may be more punitive
- *Terms and Conditions*: Covenants in the quota-share agreement or other underwriting agreements generally determine whether the interests of the sidecar investors and the sponsoring reinsurer are aligned
- *Indemnifications and Carve-Outs*: The risks that the sponsoring company retains are expected to be fully described
- *Documents*: Structural, regulatory, legal, and all third-party related documentation are reviewed, although AM Best may review the sponsor's adviser's interpretation of such documents
- *Collateralization*: The level and form of the collateral, including investment guidelines and the conditions for release of the collateral, are examined to ensure that these are appropriate for the rating
- *Ongoing Risk Monitoring*: The mechanism by which ongoing risk monitoring will occur is examined to ensure that AM Best will be able to re-evaluate the credit risk of the sidecar on a timely basis
- *Management of Aggregate Risks*: Evaluating how the risk layers are correlated
- *Degree of Peril Modeler Involvement*: The degree of involvement of established peril modelers which can range from simply making sure that the sponsors turn on the "right levers" on licensed software to actually modeling the peril and verifying data quality. AM Best views transactions that are modeled independently (with data verification) more favorably than those that are all modeled in-house with little or no input from third-party peril modelers.
- *Risk Analysis*: Exceedance probability curves, probability of attachment, and exhaustion points should be provided. AM Best will ask for base and stressed exceedance probability curves to determine losses accrued to the vehicle

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- *Reserves:* The procedures for the establishment and liquidation (run-off) of reserves are examined for appropriate sizing and maintenance
- *Key Assumptions on Business Profitability:* Specific assumptions used in modeling premiums and loss ratios earned/experienced by the sidecar, including assumed volatility of such premiums and loss ratios, are critical to the analysis because these are major drivers of the attachment probability associated with the debt
- *Cash Flow Model:* Review of the cash flow model to understand the critical assumption used in determining the profitability of the sidecar is an important element in the tail risk analysis
- *Profit Distribution:* Details on the circumstances under which profits can be withdrawn from the sidecar for distribution to investors (and the timing of such distributions) are expected to be well defined
- *Business Origination:* The projected business origination (including breakout of retrocession business) and how AM Best is alerted to deviations from the plan may factor into the assessment
- *Protected Cell Structure Mechanics:* If the sidecar has a protected cell structure, the structure and the limits of each cell are reviewed to determine whether each cell truly operates independently with its own capital to absorb losses up to predefined limits. Perils covered in individual cell structures are stressed more than those wholly contained in dedicated, special-purpose reinsurance vehicles.
- *Operational Risk:* The record keeping needed to maintain the legal separation of the sidecar from the sponsoring insurance company to ensure the bankruptcy remote nature of the transaction may be considered
- *Advisers:* Tax and legal advisers are particularly important because these entities ensure the validity of the documentation
- *Reporting Requirements:* Availability of financial statements, procedures for reporting material events and exposure information may factor into the assessment

C. The Assignment of a Rating

The ratings assigned are as follows: 1) *Best's Long-Term Issuer Credit Rating*, is an opinion as to an issuer's ability to meet its ongoing senior financial obligations and, if the sidecar has issued debt, 2) *Best's Long-Term Issue Credit Rating*, is an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligations.

The rating assigned to catastrophe-linked securities or structures is based on *Best's Idealized Issue Default Matrix* or *Best's Idealized Issuer Default Matrix* (Issue Default Matrix) as displayed in *Best's Insurance-Linked Securities and Structures Methodology* (BILSM). For ICRs, the probabilities of exhausting the capital in the sidecar are applied to the *Issuer Default Matrix* using the appropriate term to arrive at a rating. For IRs,

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the modeled attachment probabilities are applied to the Issue Default Matrix using the appropriate term of the debt to arrive at a rating.

Considerations that come into play in rating either a sidecar or its debt may include: the level of comfort AM Best has with the modeling of the peril; the stress on the attachment points (via the increase in peril frequency); stresses on loss ratios (depending on whether catastrophe or working-layer risks are being evaluated); the concept of “multiple event triggers” with respect to catastrophe-linked securities or entities; zonal and leverage risk limits; and other factors that may affect the credit quality of the security or entity being evaluated.

Published by A.M. Best Rating Services, Inc.
METHODOLOGY AND CRITERIA

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Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Best's National Scale Rating (NSR): a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services, Inc. (AM Best) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AM Best.

