

A.M. Best – Overview of Financial Strength Ratings (FSR) for Captive Insurance Companies

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Today's presentation

- Introduction to A.M. Best and ratings
- Rating of captives & PCCs
- Benefits of captive & PCC ratings
- Rating factors & methodology
- Rating process
- Concluding comments & follow up

- Additional information
 - Characteristics of highly rated captives
 - Sample meeting agenda
 - Typical rating information request



A.M. Best overview

- Established in 1899 in the US
- Only international rating agency focused almost exclusively on the insurance industry
- The world's leading provider of insurer Financial Strength Ratings (FSR) by company coverage (over 4000 companies in 65+ countries)
- Dominant position in the US market e.g. >99 % of P&C GWP
- Over 200 + rating professionals located in New Jersey (US), London & Hong Kong
- Rating methodologies published for specific sectors e.g. captives & protected cell companies (see www.ambest.com)
- Extensive marketing & publishing capability to promote corporate ratings in local & international markets



Types of A M Best rating

- **Financial Strength Rating (FSR)**
 - an opinion of an insurer's ability to meet its obligations to policyholders
- **Issuer Credit Rating (ICR)**
 - an opinion as to an insurer's ability to meet its most senior obligations
- **Debt Rating (DR)**
 - an opinion as to an insurer's ability to meet its financial obligations to security holders when due
- **Insurance Linked Securities (ILS) ratings**
 - an opinion as to an insurer's ability to meet its financial obligations to security holders when due



A.M. Best Rating Scales

	FSR	ICR		FSR	ICR	
Secure	A++	aaa aa+	Investment Grade	B	bb+ bb	Non-Investment Grade
	A+	aa aa-		B-	bb- b+	
	A	a+ a		C++	b b-	
	A-	a-		C+	ccc+	
	B++	bbb+ bbb		C	ccc ccc-	
	B+	bbb-		C-	cc	

FSR = Financial Strength Rating
 ICR = Issuer Credit Rating



Best's ratings are predictive

- A M Best ratings are forward-looking
- A M Best regularly produces impairment studies of its financial strength ratings
- Impairment rates consistently increase with time and rating degradation:
 - a superior rated (A++ and A+) insurer has a one-year impairment rate of 0.06% (2.07% after 10 years)
 - at the next lower rating level (A and A-), this impairment rate increases by nearly 3.5 times
 - an insurer in the vulnerable category has an impairment rate of almost 15 times that of a secure rated insurer



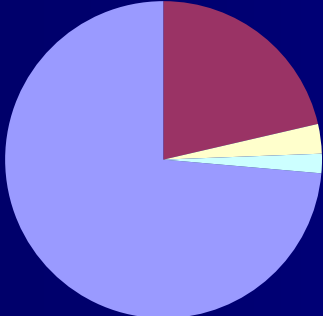
Rating of captives

- A.M. Best treats captives, PCCs, and other alternative market structures as a distinct segment for analytical purposes
- Specific captive rating methodology published in 2002 (updated in 2005)
- Over 250 captives rated including 20+ with European parents/domicile
- Increasing interest in Europe driven by corporate governance, Solvency II & fronting issues?
- Protected cell methodology published in March 2008



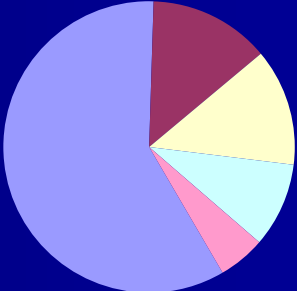
Profile of rated captives

Ratings category distribution



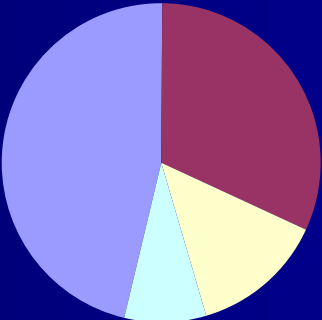
■ Excellent A, A- ■ Good B++, B+
 ■ Superior A++, A+ ■ Vulnerable

Ratings domicile distribution



■ Other US ■ Bermuda ■ Vermont
 ■ Europe ■ Cayman

Rated captives by manager



■ Self-managed ■ Others ■ Marsh ■ Aon



Cross section of current European rated captives

Company	Location	Formed	Parent	Rating		Manager
				FSR	ICR	
Casiopea Re	Luxembourg	1988	Telefonica (Spain)	A-	a-	own
Delvag	Germany	1924	Lufthansa (Germany)	B++	bbb+	own
Electric	Ireland	2005	General Electric (US)	A	a	Aon
Electro Re	Luxembourg	1986	Alcatel-Lucent (France)	B+	bbb-	own
Exporters Insurance (Europe)	UK	2006	EIC (Bermuda)	A-	a-	own
Jupiter	Guernsey	1994	BP (UK)	A+	aa-	Marsh
NGI	Isle of Man	1987	National Grid (UK)	A	a	Aon
New Technology	Ireland	2003	Carphone Warehouse (UK)	A-	a-	own
Rembrandt	Bermuda	1981	Vitol (Netherlands)	A	a	Tate & Lyle
Transmode Services	Bermuda	1978	SGS (Switzerland)	A-	a-	Atlantic Security
Western Isles	Isle of Man	1997	Interros (Russia)	B+	bbb-	Castletown

As at 18/07/08



Benefits of a captive rating

- Provides greater flexibility regarding fronting arrangements
- Enhances access to reinsurance
- Validates the financial strength and credibility of a captive, satisfying corporate governance standards
- Satisfies regulatory & other third party requirements
- Helps attract and retain members in group (multi-owned) captive organisations
- Provides captive benchmarking standards
- Increases a risk manager's control and flexibility of a group insurance programme
- Facilitates expansion into third-party business where this is a strategic goal



Benefits of a captive rating – case studies

A Best's rating...

- helped a French risk manager with a Luxembourg captive to demonstrate to divisional management that the captive was a bona fide (re)insurer
- allowed a Guernsey captive to accept South American business without the use of a 'double front'
- was required for an Isle of Man captive to be an appropriate carrier for the risks of the US division of a UK group
- was deemed necessary for a Dublin captive to write customer related insurances for its parent
- enabled a Guernsey captive to provide cover for joint venture risks, and issue acceptable insurance certificates



Typical characteristics of a rated captive

- Capital & surplus in excess of \$5m (but not a minimum requirement)
- Meaningful net risk retention
- Demonstrates strong independence from parent(s) & operating subsidiaries
- Significant third party dependency on financial strength through, for example, contractual insurance requirements or parent company joint ventures
- Has a clear strategy & business plan to develop a robust 'cross cycle' insurance business
- Strong board and independent management



Rating evaluation – Key rating factors



BCAR = Best's Capital Adequacy Ratio = $\frac{\text{Adjusted surplus}}{\text{Net required capital}}$



Specific features of rating methodology for captives

- Stand-alone assessment as if commercial insurer
- Evaluation of the parent and relationship with captive
- Nature, location and control of assets
- Independence of capital
- Dividend policy
- Post initial rating, on-going communication with captive management

Rating methodology for PCCs

- Many aspects of the standard captive methodology will be applicable
- Rating may apply to core PC company and/or individual cell (s)
- PCC company would need to be risk bearing in some capacity to attach a FSR
- For a cell rating exposure to the liabilities of other cells may be a relevant rating consideration
- Review of the relevant regulatory framework will also be key



The rating process

Interactive rating process

Receive a rating request

Compile detailed information

Meet with senior management

Perform comprehensive analysis

Determine Best's rating (via committee)

Disseminate Best's rating to the public

Perform ongoing surveillance & monitoring



Concluding comments & follow up

- Anticipate ratings demand to increase but not suitable for many 'standard' captives
- Identification of 'target' captives for further discussion - with captive managers e.g.
 - group / multi-owned
 - PCCs
 - direct writers
 - third party business involvement
 - independent financially strong entities
- Include in feasibility studies & ongoing 'best practice' captive management review checklist
- Contact A. M. Best for additional information



Appendices



Characteristics of highly rated captive insurance companies (1)

- Quantitative Factors
 - Strong permanent policyholders' surplus, supportive of growth and generated primarily by retained earnings
 - Consistent, positive operating performance, recognising the nature of the captive as an insurer for related risks
 - Appropriate net retentions commensurate with the nature of the risks insured and the level of policyholders' surplus in the captive.
 - Conservative setting of reserves
 - Optimal reinsurance programme
 - Well-developed investment programme supporting the cash flow and long-term liabilities of the risks assumed by the captive
 - Sound liquidity
 - Captive's meeting of stakeholder expectations (mission)



Characteristics of highly rated captive insurance companies (2)

- Qualitative Factors
 - Focused and knowledgeable captive management team
 - Effective, value-added risk-management and loss-control programmes
 - Demonstrated interest and support by parent or members in captive's activities, performance and financial strength
 - Strong underwriting and claims-handling capabilities to maintain the business mix written and exposures assumed
 - Defensible market position
 - Good geographic spread of risk
 - Ongoing, open dialogue with A.M. Best analysts



Sample rating meeting agenda (1)

- **Organisation**
 - Corporate Structure
 - History of captive and owners/members [Initial rating only]
 - Mission of captive [Initial rating only]
 - Management and board of directors

- **Underwriting**
 - Business strategy and marketing overview
 - Distribution strategy including mix of business and how it may evolve
 - Geographic distribution of exposures
 - Catastrophe exposures
 - Underwriting process and criteria
 - Policy limits, per occurrence and in the aggregate
 - Risk-management and loss-control programmes
 - Regulatory environment

- **Claims and Loss Reserve Practices**
 - Severity and frequency trends
 - Review of large losses
 - Claim-handling practices and vendor management
 - Actuarial analyses



Sample rating meeting agenda (2)

- **Reinsurance**

- Primary and catastrophe reinsurance programmes
- Anticipated changes to reinsurance at upcoming renewals
- Cost-benefit analyses of self-insured retentions
- Results of participation in reinsurance pools

- **Financial Analysis**

- Financial statements review
- Details of debts, loan backs, indemnity agreements and letters of credit
- Capital adequacy for risks assumed
- Investment portfolio review, strategies and guidelines
- Expense management
- Dividend plans
- Technology initiatives
- Overview of rating process and issues impacting financial strength



Typical rating information requested (1)

- Annual financial reports – latest five years preferably or credible projections for a less-experienced or start-up company
- Audited financial statements for parent and subsidiary companies, if applicable
- Actuarial reports, both internal and external
- Corporate structure and history
- Management structure and key executive committees
- Biographical information on principal officers
- Operating business plans
- Capital management strategies



Typical rating information requested (2)

- Completed Best's Supplemental Rating Questionnaire
- Any other information management believes is relevant to the rating process
- Any other reasonable information requested by A.M. Best including not limited to:
 - a) Estimated impact (net and gross) from catastrophe or other unusual events
 - b) Details of changes in ownership, management, products or operations
 - c) Projection of year end results
 - d) Plans to mitigate losses and/or to correct an identified problem
- Pro forma projections for captive and parent, as applicable
- History of losses and premiums
- Organisation structure for parent organisation and subsidiaries
- Additional data as needed



Rating factors

- **Balance sheet strength**
 - Best's capital adequacy ratio (BCAR)
 - Capital structure
 - Leverage / capitalisation
 - Reinsurance programme
 - Adequacy of loss reserves
 - Quality & diversification of assets
 - Liquidity
- **Operating performance**
 - Profitability
- **Business profile**
 - Operating strategy & business plan
 - Marketing strategy & competitive environment
 - Product & geographic concentration
 - Country risk



A M Best ratings track record

	1-Year	5-Year	10-Year	15-Year
A++/A+	0.06%	0.68%	2.07%	4.18%
A/A-	0.19%	2.20%	5.33%	7.84%
B++/B+	0.75%	5.59%	10.69%	14.86%
B/B-	2.07%	10.03%	18.95%	26.14%
C++/C+	3.39%	13.46%	24.57%	29.66%
C/C-	6.00%	16.74%	31.09%	40.70%
D	7.34%	25.54%	40.84%	49.35%

Secure	0.25%	2.24%	5.00%	7.58%
Vulnerable	3.65%	14.79%	26.04%	33.52%
All	0.71%	3.82%	7.69%	10.98%

Data from Best's Impairment Rate and Rating Transition Study – 1977 to 2007 published April 21, 2008



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