The Pros and Cons of A.M. Best Ratings for Captives

Presented by
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President & CEO
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Presented to the SIIA National Educational Conference
Orlando, Florida
September 23, 2009

A bit about

- Writes excess liability insurance exclusively for public entities.
- Conceived during the hard market of the mid-1980s.
- Was first rated by A.M. Best Co. in 1991.
- Withdrew from A. M. Best rating program in 2008.
A.M. Best’s comments

- Based on comments made by Best representatives during meetings and the public presentation they made in Vermont in May, 2007, a number of significant issues were identified...

A.M. Best’s comments

- The criteria and formulas used by Best to rate Risk Retention Groups (RRGs) are essentially identical to what they use to rate commercial insurance companies.
Some of the critical criteria evaluated by A.M. Best:

- Diversity in the type of organizations/risks being insured.
- The writing of multiple lines of insurance.
- The amount of risk being transferred to reinsurers.
- The amount of capital and surplus being maintained by the insurer.

RRG Traits

- FLRRA of 1986: RRGs can only provide insurance to a homogeneous group of organizations.
- FLRRA of 1986: RRGs cannot write multiple lines of insurance; can only write third-party liability coverage.
- Most RRGs rely on financially strong reinsurers to provide their insureds with a financially strong program.
- Commercial insurance companies generally exist to build large surpluses in order to retain more risk and, more importantly, to pay dividends to their stockholders.
- RRGs are generally created to maintain a reasonable level of capital and surplus and to provide their members with the best liability coverage they can at the best price for the risks being underwritten.
Observation

- A.M. Best’s rating criteria tends to discriminate against RRGs.

Other Factors
RRG statistics*

- As of 7/1/09, there were 254 RRGs operating in the U.S.
- Of those RRGs, 27 (just over 10%) are rated by A.M. Best Co.

*Sources: National Risk Retention Association and The Risk Retention Reporter.

Rating agency fees

- Rated companies, including RRGs, that are rated by rating agencies pay a fee to participate in their rating programs
  - As opposed to the rating agency being paid by those using its ratings.
- This cost is usually based on the capitalized size of the entity being rated.
- The cost ranges from a few thousand to several thousand dollars.
RRG regulation & oversight

- RRGs are required to file quarterly financial reports with regulators in their state of domicile as well as with regulators in every state in which they want to operate.
- RRGs generally undergo an intense audit of their financial, underwriting and claims records by their state of domicile on a regular basis.
- RRGs undergo an independent audit annually, and this audit is filed with their state of domicile and all other states in which they want to operate.
- RRGs are required to file an annual actuarial study with their state of domicile and in all of the states in which they want to operate.
- RRG underwriting, financial and claims files are generally audited by their reinsurers on a regular basis.

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Steven M. Chirico CPA- Assistant Vice President
A.M. Best Company

About Best’s Ratings

- Recognized worldwide as the benchmark for assessing insurers’ financial strength.

- Reflect an in-depth understanding of business fundamentals garnered from more than 100 years of focusing solely on the insurance industry.

- Independent third-party evaluation that subjects all insurers including captives to the same rigorous criteria, providing a valuable benchmark for comparing insurers, regardless of their country of domicile or format.
A.M. Best Company Overview

Full service rating capabilities
- Financial Strength (FSR)
- Issuer Credit Rating (ICR)
- Debt
- Commercial paper
- Other insurance-related transactions

Established markets
- A.M. Best (New Jersey)
- A.M. Best Europe (London)
- A.M. Best Asia-Pacific (Hong Kong)

Property Casualty & Life Health
- Personal Lines
- Commercial Lines
- Reinsurance
- Specialty
- Alternative markets
  - Domestic/Offshore
    - Alternative Risk Transfer
      - Captives & Protected Cells
  - Title insurance
  - Managed Care
    - HMO, BCBS, Dental

Users of A.M. Best Ratings

- Insurance Companies
- Agents
- Brokers
- Regulators
- Policyholders
- Financial Institutions
- Investors
- Academics
- Employee Benefits Managers
- Corporate Risk Managers
- Consultants
- Consumers
- Reinsurers
- Captive/Alternative Risk Managers
- Debt and Equity Research Analysts
- Investment Professionals
- Government Agencies
A.M. Best’s Financial Strength Ratings

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<tr>
<td>B++, B+</td>
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<tr>
<td>B, B-</td>
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<td>C++, C+</td>
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<td>F</td>
<td>In Liquidation</td>
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Public Data Ratings Designated by a pd subscript

A.M. Best Company
The value of a rating

- Independent Third Party Oversight
- Greater Transparency
- Validate Financial Strength and Credibility
- Satisfy Regulatory Requirements
- Enhance Access to Reinsurance
- Provide Greater Flexibility Regarding Fronting and Reinsurance Arrangements
- Facilitate 3rd Party business (if desired)
- Benchmarking Standards
- Increase Control of an Insurance Program
- Ongoing Monitoring
Ratings Process
30K Foot View

A.M. Best’s Rating Evaluation
Key Components

- Balance Sheet
- Operating Performance
- Business Profile

Best’s Rating
**How is an A. M. Best Rating Derived?**

**Introduction**
- Combination of quantitative measures and qualitative information
- The rating process is interactive
- A rating is a customized affair – no one size fits all

**Quantitative Analysis**
- Risk adjusted capitalization is measured by Best’s Capital Adequacy Ratio (BCAR)
- Operating performance is measured by analyzing income and cash flow metrics
- Operational leverage measures are used to supplement BCAR
- Financial leverage measures of Parent Co.
- Net retention to surplus is important
- Thorough assessment of management
- Operational sustainability is analyzed
- Financial flexibility is considered
A. M. Best Rating Process

Internal

- Analysis team meets with management and prepares the analysis
- Analysis team presents to a peer review committee (PRC)
- PRC votes to determine rating assignment
- There are higher level review committees if needed

External

- Final rating determination is communicated to company
- Company has three days to appeal
- President’s Letter, rating report, and press release draft sent to company for approval
- Rating is published in A. M. Best products and in the public domain (Business Wire)
A.M. Best Rating Process
Minimum Documentation

- Audited financial statements (both Parent and Captive)
- Actuarial Report
- Reinsurance and vendor contracts
- Face-to-face meeting encouraged
- 3-5 year projections and business plan
- PML and/or Terrorism study
- Management Bios
  - Note: Each rating is customized to reflect form of rated entity. Additional information may be required

Rating Considerations

- Management
- Business Profile
- Sponsors/Strength
- Operating Performance
- Enterprise Risk Management
- Balance Sheet Strength
Rating Fallacies Dispelled

- There is a minimum size requirement – **There is no minimum size. The smallest captive we rate is a pure captive with $1.5 million in surplus.**

- There is a minimum experience requirement – **There is no history requirement. A. M. Best rates start-up captives.**

- A. M. Best rates captives with the same methodology as commercial insurers – **A. M. Best rates captives with a separate captive methodology specifically designed to capture the risks and benefits of the captive structure and operating mentality.**

Captives: Rating Problem Areas

- Must be bona fide alternative risk vehicle

- Net per occurrence retention compared to surplus of more than 10% is a non-starter

- Arm’s length transactions

- Taking too much risk on both sides of the balance sheet

- Excessive growth

- Sufficient normal insurance documentation
More Information Available on AMBest.com

- Captive Methodology
- Protected Cell Company Methodology
- U.S. Captive Market Statistical Report
- New Company Rating Methodology

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