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Best's
Methodology and Criteria

DRAFT: Rating Captives and Other Alternative Risk Transfer Entities

Daniel Ryan
908 882 2290
Daniel.Ryan@ambest.com

Mathilde Jakobsen
+31 20 308 5427
Mathilde.Jakobsen@ambest.com

Dan Teclaw
908 882 2390
Dan.Teclaw@ambest.com

Robert Raber
908 882 2261
Robert.Raber@ambest.com

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Outline

A. ART Entities – Overview
B. Balance Sheet Strength
C. Operating Performance
D. Business Profile
E. Enterprise Risk Management

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 AM Best's rating process.

A. ART Entities Overview

AM Best categorizes Alternative Risk Transfer (ART) entities into the following broad groupings: single-parent (and pure) captives, group captives, risk retention groups, self-insurance funds, and cell companies. Their unique characteristics are discussed in the following sections.

Single-Parent and Pure Captives

Single-parent captives are owned by one company or group (the parent). Pure captives are single-parent captives that accept only the risks of the owner (or owner-affiliates). Not all single-parent captives are pure captives; in some instances, a single-parent captive can accept business from third parties.

Group Captives

Group captives offer insurance to multiple unrelated policyholder owners and can take many forms. Some group captives dedicate themselves to a particular industry, while others choose to write in a limited geographic area, such as a single state. Group captives are the ART entities that most resemble a commercial insurer and have similar rating dynamics.

Risk Retention Groups

In the US, risk retention groups (RRGs) are governed under the Liability Risk Retention Act (LRRA) and designed to provide liability insurance for a consortium with similar business interests. Under this federal statute, an RRG is (except as specifically designated by LRRA) subject only to the regulatory authority of its domicile state, even if it is a multistate insurer. This has implications for the rating

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process when considering the treatment of substitute forms of capital, particularly qualifying letters of credit (LOCs) and New York Regulation 114 trusts.

Self-Insurance Funds

Several US jurisdictions allow for self-insurance funds as an alternative form of insurance. By definition, these types of ART instruments can write selected coverages only for policyholder owners doing business in that particular area. These funds differ from commercial insurers in two ways: They are (1) subject to joint and several liability for any claims and (2) are governed under a specific charter whereby the surplus is fully composed of subscribers' savings accounts. "Joint and several liability" stipulates that all of the subscribers' savings accounts and all of the policyholder owners' assets can be used to satisfy any claims.

Cell Companies

A cell company (CC) is a highly complex and flexible framework that can be used in a variety of ways by multiple users and sponsors. These can hold any number or a combination of insurance and financial operations, transactions, or instruments.

In this criteria procedure, and in line with most jurisdictions, a CC is an entity composed of a core and one or more incorporated or unincorporated cells in which the assets and liabilities of any given cell are segregated from the assets and liabilities of all other cells, and possibly the assets and liabilities of the core.

Various names are used to refer to CCs across the many domiciles that have passed cell company legislation. This criteria procedure encompasses any organization sharing these traits, regardless of the preferred naming conventions of the company's regulator or domicile:

- An incorporated cell company (ICC) is a company composed of a number of individual cells, each of which is a separate incorporated legal entity. Each individual incorporated cell (IC) can hold its own insurance license, issue policies, and enter into transactions with third parties.
- An unincorporated cell company (UCC) is composed of a number of individual cells. In this case, only the UCC is an incorporated legal entity, and the individual unincorporated cells (UC) may not be considered separate legal entities. The individual UCs are unlikely to be independently licensed and therefore insurance policies are issued by the UCC on behalf of the individual UCs.
- A mixed cell company (MCC) is composed of both ICs and UCs.

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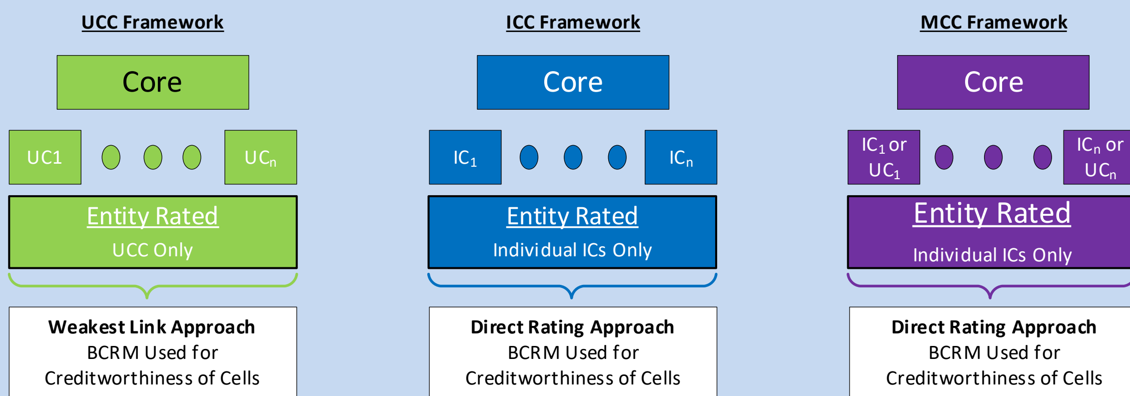
Rating Factors for Cell Companies

Given the growing use of cell companies, and the variety of dynamics across the industry for these companies, additional clarifying detail is necessary to outline the process under which these companies may be assigned Issuer Credit Ratings (ICR) and Financial Strength Ratings (FSR) using this criteria procedure. The overarching process is outlined in **Exhibit A.1.**

Exhibit A.1 Rating Process for Cell Companies (CCs)



Principles/elements in the diagram may apply to entities such as series LLCs and other frameworks that have the look and feel of cell companies.

For UCCs, AM Best will rate only the UCC entity overall and will not assign separate ratings to individual UCs under this criteria procedure. This reflects the fact that only the UCC as a whole is an incorporated and licensed legal entity.

When owners or co-owners of the UCs are unaffiliated with the owner(s) of the UCC, each UC will be evaluated individually based on the BCRM, which includes the building block approach. Although each UC will be evaluated individually, this analysis will be conducted in conjunction with the analysis of the core and the core's owners.

The rating of the UCC is informed by the creditworthiness of the weakest individual UC as evaluated following the BCRM, referred to as the "weakest link approach." Since only one rating is assigned to the UCC as a whole, the rating must take all policyholder obligations into consideration and is therefore capped by the creditworthiness of the weakest cell.

Default risk and operational risk increase with the addition of each UC to the UCC. Therefore, as the number of UCs in a UCC grows, AM Best may assign a rating to the UCC that is, at a minimum, one notch lower than the rating determined by the weakest link approach. Circumstances under which the weakest link approach will be maintained, and notching will not apply, include when any of these are present:

- The creditworthiness of the UCs is generally evaluated as "aa-" or higher.
- Additional support via reinsurance, pooling, or capital maintenance is available from the core, other UCs, or from other sources.
- Capitalization and business profiles are generally uniform across the UCs.

Affiliated CCs

When an insurance group establishes its own CC and divides the risks into a number of cells (i.e., a CC in which all the cells are affiliated), AM Best will, as a starting point, apply the weakest link approach in the same way as it approaches CCs that consist of unaffiliated cells. However, if the CC is determined to be run in the same way as a conventional insurance company, and if each cell is expected to be supported equally, it may be treated on a consolidated basis and as a single entity for rating purposes.

In the same way, when an organization (with a non-insurance focus) establishes its own CC and divides the risks into a number of cells, the CC will essentially be treated like a pure captive insurer for rating purposes.

ICCs

AM Best may assign ratings to one or more individual ICs, reflecting that each of the ICs in an ICC or an MCC is an individually incorporated and licensed legal entity. An IC's reliance on the ICC or MCC, e.g., for management or administrative support, will be taken into account as part of the assessment of business profile and enterprise risk management (ERM).

Given the growing use of CCs as a risk management tool for innovative and creative (re)insurance transactions, along with evolving regulatory frameworks for CCs, AM Best may conduct further analytical assessments. This would include in-depth discussions with jurisdictional authorities, third-party legal reviews, or consultations with external actuaries. As part of this process, items to be reviewed may include the following:

- Cell company laws, including any jurisdictional legal precedents that may change the way AM Best views the sanctity of cells
- Rules about the bankruptcy and dissolution of cells, including the history of disputes related to cell structures in the jurisdiction in which the cell company is formed
- The use of entities such as series LLCs or other vehicles that resemble cell companies
- Issues that may arise regarding how ICs and UCs can interact with each other under the same MCC
- Structure of the transactions the cells engage in
- Interpretation of funding agreements, reinsurance contracts, dispute resolution mechanisms, and other legal agreements
- Loss profile of the business being conducted in a UC, IC, or series LLC, especially for asset classes without publicly available performance data
- Limitations of loss data and alternative data sets that may approximate the performance of the subject business
- Fulfillment of certain regulatory requirements, if applicable, when the cells are used for issuing securities

For UCCs and ICs that issue structured finance instruments, AM Best will not assign an FSR. *

* AM Best defines structured finance instruments as a security or money market instrument issued by an asset pool or as part of any asset-backed securities transaction and includes transactions collateralized by actively managed pools of loans or receivables (e.g., commercial and residential mortgages, corporate loans, auto loans, education loans, credit card receivables, and leases), collateralized debt obligations, collateralized loan obligations, collateralized mortgage obligations, structured investment vehicles, synthetic collateralized debt obligations that reference debt securities or indexes (including catastrophe-related indexes or activities), and hybrid collateralized debt obligations. This includes liability transactions such as catastrophe bonds. (Note that this definition is broader than the definition of asset-backed securities pursuant to Form NRSRO.)

The Rating Process

There are some key differences in the way that ART entities operate that affect the rating process and the building block assessments (outlined in **Exhibit A.2**). These considerations are discussed in the following sections, as are any instances in which the availability of the BCRM assessment descriptors (**Exhibit A.3**) differs from the process outlined in the BCRM.

Exhibit A.2: AM Best's Rating Process

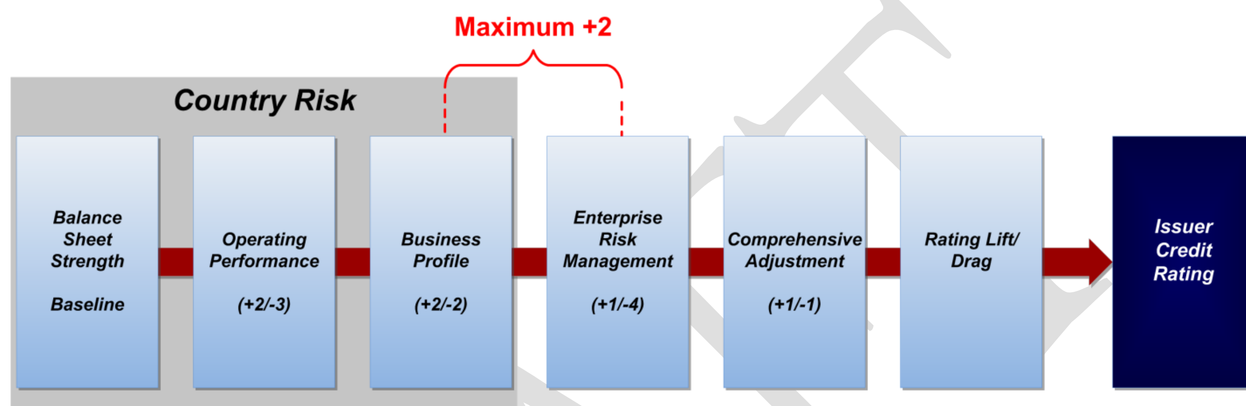


Exhibit A.3: BCRM Assessment Descriptors

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

B. Balance Sheet Strength

Treatment of Letters of Credit

Letters of credit take many forms and typically are treated as debt in the rating process, whether for a commercial insurance carrier or an ART entity (most often a single-parent captive). LOCs can be used to capitalize an ART entity, an arrangement encouraged by a number of captive insurance regulators, to help an ART entity access capital if needed. As a result, an LOC may have more equity-like characteristics, which could result in equity credit for Best's Capital Adequacy Ratio (BCAR) purposes

depending on the details of the LOC arrangements. LOCs eligible for consideration will adhere to most, if not all, of the following:

- Standalone
- Evergreen
- Irrevocable
- Drawn on a highly rated bank

"Standalone" means that the instrument is not part of a credit facility or agreement that may contain covenants and terms that can impair the LOC's liquidity. "Evergreen" and "irrevocable" mean that the instrument automatically renews and cannot be canceled except by prior written agreement by all parties. "Drawn on a highly rated bank," means the LOC is funded by assets on deposit in a bank with a favorable credit rating. This ensures that the bank takes the risk if the assets fall short of the face amount and that the credit risk of the bank does not cause an undue reduction to equity credit.

The LOCs that have these elements may receive up to 100% capital credit, which may not be subject to the usual threshold of 20% of total available capital. Qualifying New York Regulation 114 trusts under similar conditions can receive capital credit as well.

Net Retention to Surplus

An ART entity's balance sheet strength assessment can be adversely affected if the company writes a net aggregate per-occurrence limit greater than 10% of total available capital. This typically occurs when an ART entity provides large limits protection on high value properties or indemnity protection on high excess liability exposures. Such exposures may or may not be modelled. AM Best may use information it deems relevant to estimate potentially large losses, such as the entity's full retained loss limit at all of the confidence levels in the BCAR model, or by using a metric such as a probable maximum loss, which is viewed as being more appropriate when considering the particular risk(s) involved and the assumptions and data supporting the assessment.

Loan-Backs to the Parent Company

Captives may want to make a loan of working capital to the parent organization for a number of reasons. To give these loans consideration in the rating analysis, AM Best expects that domicile-approved loan-backs will be documented properly with an arms-length loan agreement. The loan-back is then charged a risk factor that takes into account the risks associated with the loan, which may include a single large investment charge. The largest risk is generally the parent company's credit risk, which is assessed via external credit ratings (when available) and internal financial analyses. A loan-back may pose other risks—relating to the strength of the loan-back agreement and the parent company's cash flow volatility, for example—that may factor into the assessment. The aggregate amount of the captive's LOCs and loan-backs relative to its total capital may also affect the assessment.

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Parent / Holding Company Assessment

For ART entities, a holding company impact review is not part of the balance sheet strength assessment process for lead rating units with non-insurance parents (such as captives). Instead, the impact of the non-insurance ultimate parent is captured in the rating lift/drag assessment. However, for ART entities whose ultimate parent company is considered to be an Insurance Holding Company (IHC), the balance sheet strength assessment will include an analysis of the IHC impact.

Balance Sheet Strength Considerations for Different Types of ART Entities

RRGs

RRGs are distinct from other types of insurers in that only member insureds (policyholders) can be owners and only owners can contribute capital to the company. A sponsoring enterprise such as managing general agents (MGA) or third-party administrators (TPA) may form and administer an RRG, but they cannot make direct capital contributions as they are not the owners of the RRG. Instead, these sponsors can provide a qualifying LOC or surplus note, to which AM Best may consider giving available capital credit in BCAR if conditions warrant.

Self-Insurance Funds

AM Best generally gives full credit in BCAR to subscribers' savings accounts, depending on the specifics of the individual self-insurance fund.

Cell Companies

UCCs

AM Best considers a CC to be only as strong as its weakest cell. Therefore, the onus is on the CC to ensure that each of its cells is adequately capitalized. AM Best will review available financials for CCs and their cells. Assuming that the designated individual cells bear all of the risk, the balance sheet strength analysis will focus on the individual cells and the likelihood of a cell eroding both its own capital and that of the CC. The evaluation will examine each cell's financial condition, risk profile, loss and incurred but not reported (IBNR) reserves, as well as the credit exposures it has accumulated. In addition, any contractual relationships with other cells and with the CC will be reviewed.

AM Best reviews any contractual arrangements the CC maintains with its cells to determine how much, if any, financial flexibility the arrangements afford. These arrangements may take the form of capital maintenance guarantees, stop-loss agreements, or other similar arrangements among the cells. The contracts need to be examined to determine the extent of these liabilities, as well as any risk-sharing among the cells.

ICs

The balance sheet strength assessment of an IC will focus on the analysis of its segregated funds. This will include analysis of a stress scenario, and reviews of the IC's financial flexibility and access

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to additional funding if needed. AM Best's focus will be on mechanisms available to an IC to obtain capital.

C. Operating Performance

The purpose of captives and other alternative risk entities is to provide consistent, tailored coverages at stable pricing to policyholder owners. As expected, the use of these entities increases during periods of capacity shortages and price volatility in the commercial insurance market. Therefore, alternative risk entities typically focus more on preserving capital rather than on generating returns for shareholders. For example, a captive that pays dividends may record solid profitability before policyholder and stockholder dividends and may have lower levels of underwriting and net income available to common shareholders. In this case, consideration is given to return measures and performance metrics before and after dividends, noting the historical purpose for the dividends.

AM Best views operating performance as a leading indicator of future balance sheet strength and long-term financial stability. In general, when evaluating an entity's operating performance, AM Best looks closely at the stability, sustainability, and diversity of earnings streams. However, in the case of a captive or other alternative risk entity, risks are typically more limited in scope. Therefore, net exposure may be large relative to premium income and some operating volatility in results is expected and recognized as part of its unique mission and strategy. AM Best considers the stakeholders' history and projection of actuarially needed premium to support an expected level of losses, augmented by analysis of loss reserve development. Further, AM Best will look at longer-term profitability metrics, taking into account the potential for occasional outsized losses.

D. Business Profile

In general, an ART entity would not receive a business profile assessment higher than "Neutral." AM Best recognizes the unique nature of the relationship between the ART entity and the insured, and its impact on business profile. ART entities can have customized coverages, customer-specific claims, and loss-control solutions, and owner-insured representatives on their boards.

Business Profile Considerations for Specific Types of ART Entities

Single-Parent Captives

As prescribed in BCRM, the analysis of a single-parent captive's business profile includes sub-assessments of the same attributes as general commercial insurers and reinsurers. However, AM Best considers the captive's relationship as policy issuer to its insured parent as inherently favorable in specific sub-assessments of market position, degree of competition, and control of distribution. These attributes in the parent/policyholder's view of the captive reduce underwriting expenses (but not necessarily fronting costs) when compared with purchasing coverage in the traditional commercial market. Single-parent captives' business profiles may be constrained to "Limited" with

concentrations in policyholders (including affiliates); products; lines of business; and geography, although many also may have broad enough diversification in products, lines of business, and geography to warrant a "Neutral" profile.

Group Captives and RRGs

Insured renewals and policyholder retention for group captives and RRGs tend to be much higher than for commercial insurers. Group captives and RRGs gain and retain business by providing narrowly defined and very specific products to address the particular needs of their member policyholders. Policyholder dividends and value-added services such as risk mitigation and loss control have enabled these ART entities to hold onto customers even during soft insurance cycles.

CCs

Given the variations in the legislative and regulatory provisions and enforcement mechanisms in different domiciles, the regulatory framework under which CCs are established is a key component in the business profile assessment.

CCs have a wide variety of applications and uses. They are established for extended use and to operate as a going concern. Therefore, AM Best expects objective strategic planning and forward-looking projections of financial performance. Regional or local authority and legal precedent will be applied to understanding the CC's role and will include separation of an individual cell from any cells being collectively managed.

UCCs

A CC's business profile assessment will include analysis of each cell's business profile characteristics, together with the analysis of any shared areas such as management quality and regulatory risk.

ICs

The business profile assessment of an IC will focus on the specific attributes of the IC on a standalone basis. The analysis will include a review of the core's ability to provide management and administrative support.

E. Enterprise Risk Management

AM Best will assess the risk management framework and profile/capability of the ART entity, relative to any parent company's business operations when applicable.

ERM Considerations for Different Types of ART Entities

Single-Parent Captives

AM Best views the ERM of a single-parent captive as an extension of the parent's ERM. These captives are normally formed owing to a corporate parent's desire for efficient risk mitigation and

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management, along with loss prevention and control. They are frequently housed in a corporate treasury or insurance department and are therefore fully integrated within the corporate parent's ERM operations. Single-parent captives reflect the parent's knowledge of its own risk and losses and acceptance of its risk tolerance and appetite.

Group Captives and RRGs

The ERM assessment for group captives and RRGs is similar to that for a commercial writer and focuses on the captive's risk management framework and risk profile relative to its capabilities.

CCs

The control and monitoring of any CC program is crucial to ensuring that the expectations for responding to claim incidents will be met. The CC's ERM framework processes should include measures taken to address concerns around the capabilities and limitations of individual cells.

Other important risk considerations include the type of CC used—whether open or closed to new business, or some variation in between—as well as the contractual relationships among the cells in the program, and between the cells and the core. A CC's ERM analysis will include highly specific issues applicable to this framework, including consideration of its ability to manage the segregation of cell assets and liabilities from other cells and mitigation of reputational risk as a consequence of the weakness of affiliated cells. Fronting and reinsurance agreements are also examined in detail to determine whether the cell program will be adversely affected by the provisions in those agreements.

UCCs

UCs do not typically have separate ERM functions but instead rely on the captive manager or sponsor of the UCC for ERM support. The ERM assessment of UCCs will nonetheless take into account the different risk profiles of their UCs depending on the nature of their business. Similarly, the ERM assessment of ICCs and MCCs will also take into account the different risk profiles of their cells.

ICs

The ERM assessment of an IC will focus on analysis of its standalone ERM framework, as well as its standalone risk capabilities and risk profile. Any reliance on the core for ERM support will be taken into account in the analysis.

F. Appendix

CCs can be highly complex frameworks that cover many lines of insurance business, some of which may be rather esoteric. As such, AM Best expects to receive a comprehensive packet of information from the CC sponsor for the rating analysis. Examples of data and documents that AM Best may request include, but are not limited to:

- Audited financial report for the CC and any ICs

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- Key documents and agreements
  - Business plan and formation documents
  - Licenses
  - (Re)insurance policies
  - Capital maintenance agreements and pooling agreements
  - Cell management agreements
  - Shareholder or subscription agreements
  - Any other agreements between the cells or between cells and the core
- Gross and net PMLs for each cell

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A.M. Best Rating Services, Inc.
Oldwick, NJ
PRESIDENT **James Gillard**
EXECUTIVE VICE PRESIDENT & CSO **Andrea Keenan**
SENIOR MANAGING DIRECTORS **Edward H. Easop, Stefan W. Holzberger, James F. Snee**

AMERICAS

WORLD HEADQUARTERS
A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY
A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcadía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)

LONDON
A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM
A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*
A.M. Best Europe - Rating Services Ltd. - DIFC Branch*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780
*Regulated by the DFSA as a Credit Rating Agency

ASIA-PACIFIC

HONG KONG
A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE
A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
Phone: +65 6303 5000

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