

A.M. BEST

SPECIAL REPORT

MAY 2002

A.M. Best's Rating Methodology for Single Parent Captive Insurance Companies

A.M. Best's Perspective

The alternative risk transfer market has expanded significantly over the past twenty-five years as large companies discovered coverage and cost advantages in bypassing traditional insurance channels for their property, casualty and even some life and health risks. In the beginning, they exclusively favored self-insurance and captives. Later, some companies opted instead for multi-year policies and blended programs. Now capital market solutions have the attention, if not the premiums, of many Global Fortune 500 companies. Today, the migration of risks and premiums out of the traditional commercial insurance market continues, although not to the same degree, with mid-sized companies. Specific domiciles are catering to this segment, and segregated cell legislation makes this option more available to smaller companies.

Management of a single parent captive now

faces rapidly changing financial and business conditions and rising visibility within its parent organization. Increasingly, many of these captive insurers are seeking the advantages of a financial strength rating from A.M. Best. Established in 1899, A.M. Best is the world's oldest and premier provider of financial information and ratings for the insurance industry.

A Best's Rating is the culmination of an independent, interactive financial evaluation of a company, involving the analysis of quantitative and qualitative factors. A Best's Rating lends instant recognition and credibility. Credibility is a fundamental prerequisite for captive insurers when dealing with parent company operational

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The Interactive Rating Process

Receive a Rating Request

An captive insurance company makes a formal request for an initial interactive rating.

Compile Detailed Information

The company is asked to provide financial statements, including regulatory filings and detailed information about their operations, reserves, business risks, and asset-liability management, as well as supplemental information captured via proprietary rating questionnaires.

Meet with Senior Management

A.M. Best analysts meet with the individual company. This meeting provides analysts with an understanding of the company's strategy and prospective performance.

Perform Comprehensive Analysis

The foundation of A.M. Best's rating analysis is the key components of balance sheet strength, operating performance and business profile.

Determine Best's Rating

Analysts' rating recommendation is approved and modified through a specific committee process that can culminate in an executive committee consisting of A.M. Best senior officers.

Disseminate Best's Rating to the Public

A.M. Best then conveys the rating decision to the company. With their acknowledgement we publicly announce the rating.

Perform Ongoing Surveillance & Monitoring

A.M. Best continually monitors current developments (i.e., reviewing public documents, news items, Internet, ongoing dialogue with management, etc.) to evaluate the potential impact on the financial strength rating. Significant developments can result in a rating being placed under review with positive, negative or developing implications.



management as well as banks, reinsurance companies, fronting insurers and regulatory authorities. No longer does the word of someone intimately involved with the company have to be relied on by either internal or external constituents; with a financial strength rating, the captive carries its own recognized standing in the business world. Further business advantage can include the captive's ability to improve terms with reinsurers and excess carriers.

Growth in the number of captive participants and in their risk-bearing capacity has triggered development of a wide array of services tailored to the industry. Further, a number of traditional insurers and reinsurers have organized dedicated departments catering to the specific needs of captives.



The service providers, as well as regulatory authorities and other interested parties, require a consistent means of determining the security and operational viability of captives. Through uniform application of tested analytical tools and processes, a Best's Rating provides that consistency, achieving a level of financial transparency that ensures respect and comparability around the world.

For some single parent captives, the changing business landscape includes expansion into third-party business generated through their parent's extensive business relationships (ie, controlled third-party business). A Best's Rating can facilitate entry into these new markets and help to level the playing field with competitors if necessary. As a well-known global symbol of financial strength, a Best's Rating also can be a key determinant in the buying decision of insurance purchasers.

Operational benefits also flow from the rating process. A.M. Best's assessment includes an analysis of a captive's performance, corroborating financial and strategic strengths and weaknesses against competitive benchmarking data. These operational benefits also can help to strengthen the confidence of parent company management.

For captives primarily seeking operational benefits, A.M. Best provides the option of not publicly releasing the rating, analysis or any financial data. The financial data garnered from these rating engagements, however, is compiled with all other captive insurers and used to track aggregates and averages on the captive industry.

A.M. Best has maintained its preeminent position as the leading provider of financial information for the global insurance industry by evolving along with the industry and meeting the needs of ever-changing markets. In response to the continuing development of the captive market, A.M. Best has committed significant resources to provide a full range of relevant financial services and products, including accurate and time-critical ratings. A.M. Best has staff, both in the U.S. and U.K., dedicated to covering the worldwide captive market and related issues.

A.M. Best's core product for this business segment is Best's Captive Directory, which provides detailed listings of captives, parent companies and service providers, as well as an up-to-date section on domicile requirements and official contacts. A supplement of financial statistics, in the form of aggregates and averages, is the first attempt at comparative studies and benchmarking within the captive industry that uses actual company data.

A.M. Best's commitment to the captive market is ongoing, involving expanded captive company data, news and ratings.

Explanation of Best's Rating Scale, Sources of Information and Financial Size Categories

To be eligible for a Best's Rating all companies, including single parent captives, must meet certain size, operating experience and risk profile requirements. Generally, companies must have (1) a minimum of US\$ 2 million in capital and surplus to assure reasonable financial stability, (2) sufficient operating experience to evaluate adequately their financial performance—usually two to five years—and (3) meaningful retention of their gross premiums written to classify them as risk-bearing

entities. Exceptions to these requirements may be made for companies that have financial or strategic affiliations with Best Rated companies or companies that have demonstrated long histories of stable financial performance.

The objective of Best's rating system is to provide consistent, uniform opinions of insurers financial strength and their ability to meet obligations to policyholders. Best's opinions are derived from an evaluation of company specific information against Best's quantitative

and qualitative standards. Such an approach allows any company the opportunity to reach the highest rating levels.

Best's Rating Scale

From highest to lowest, Best's Ratings range from A++ (Superior) to S (Rating Suspended) and are grouped into two broad categories, Secure or Vulnerable. Ratings between A++ and B+ are considered Secure; all those below B+ are considered Vulnerable. Within each broad category are several rating levels to indicate relative financial strength and operating profitability. For example, A++ and A+ comprise the Superior rating level, while A and A- comprise the Excellent category. The highest rated Secure companies have a very strong ability to meet their obligations to policyholders, while the lowest rated Secure companies have a good ability to meet their obligations to policyholders. The higher a company's Secure rating, the greater is its ability to withstand adverse changes in underwriting, economic and/or environmental conditions over longer periods. Conversely, the financial strength of a Vulnerable company is at risk of adverse changes, and its ability to meet its obligations to policyholders is only fair to weak.

Source of Information

To ensure that proper analysis is performed and an appropriate rating assigned, A.M. Best requires that extensive base line information be supplied, as well as participation in a formal meeting. The following is representative of the types of information typically requested.

Parent Company Financial Statements and Supporting Documents. Regardless of whether the parent company is publicly traded or a private concern, A.M. Best needs the latest financial statements, and any related information it deems necessary, to understand the implicit, or explicit, financial commitment

to the captive from its immediate, and if applicable, ultimate owner(s).

Captive's Mission Statement/Operating Plan. This information is vital in understanding the strategic purpose of the captive within the context of the overall organization of the parent company. The operating plan focuses on the short-term direction of the captive. This plan is reviewed for reasonableness with respect to the captive's mission and the ability of management to carry out the plan.

Audited Financial Statements. A.M. Best generally requires a minimum of five years of audited financial statements on the captive. Statutory statements are preferred for U.S. domiciled captives, if available. For all other companies, financial reports should be audited and in the format in which the entity normally prepares them. This can be in statutory form for the local domicile or any generally accepted accounting principles.

Independent Actuarial Report and Study. This information enables the analyst to gain better insight on the loss reserves reported by the captive and the underlying confidence levels selected by management. A.M. Best's internal actuaries will assist the analyst in reviewing the actuarial reports of any captive. When necessary, there can be extensive interaction with the

Financial Strength Ratings

| Secure Ratings | |
|--------------------|------------------------------|
| A++ and A+ | Superior |
| A and A- | Excellent |
| B++ and B+ | Very Good |
| Vulnerable Ratings | |
| B and B- | Fair |
| C++ and C+ | Marginal |
| C and C- | Weak |
| D | Poor |
| E | Under Regulatory Supervision |
| F | In Liquidation |
| S | Suspended |

Sample Rating Meeting Agenda

Overview & Perspective (Captive & Parent)

- History
- Business Strategy
- Corporate Structure
- Distribution Strategy
- Regulatory Environment

Review of Operations (Captive & Parent)

- Financial Statements Review
- Underwriting Overview
- Marketing Overview

- Expense Management
- Technological Initiatives
- Investment Portfolio Review & Strategies
- Catastrophe Exposure & Reinsurance Review
- Loss Reserve Review

A.M. Best Rating Discussion (Captive)

- Current Rating Status
- Best's Rating Perspective
- Ongoing Rating Contact & Communication

Typical Rating Information Requested

- | | |
|--|--|
| <ol style="list-style-type: none"> 1. Annual reports. 2. Latest financial statements for parent and subsidiary companies. 3. Actuarial reports, both internal and external. 4. Corporate structure and history. 5. Management structure and key executive committees. 6. Biographical information on principal officers. | <ol style="list-style-type: none"> 7. Operating and business plans, including financial projections. 8. Capital management strategies. 9. Completed Best's Supplemental Rating Questionnaire. 10. Any other information the captive believes is relevant to the rating process. 11. Any other reasonable information requested by A.M. Best, including but not limited to: <ol style="list-style-type: none"> (a) Estimated impact (net and gross) from catastrophe or other unusual events. (b) Details of changes in ownership, management, products, or operations. (c) Revised projection of year-end results. (d) Plans to mitigate losses and/or to correct an identified problem. |
|--|--|

captive's independent actuary to clarify its reserve position.

Questionnaires. A.M. Best requires two rating questionnaires to be filled out. One is a background questionnaire that asks for basic data, such as management, company history, and domicile information. The other, known as the Supplemental Rating Questionnaire (SRQ), is more detailed and asks for information that is not typically available in a company's financial statements. Details are requested on such items as operations, policy coverage, loss reserve discounting, investment philosophy, nature and quality of investments, asset-liability matching, derivative instruments, affiliated company transactions and investments, off-balance sheet items, catastrophe exposures and management, dividend policy, and reinsurance programs.

Investment Strategies. This information is crucial to the analyst not only in understanding investment risk but also in understanding country risk and liquidity. Investments in affiliates, control and location of physical assets as well as the terms and conditions of any notes with the parent all are important considerations.

Policies and Procedures. A.M. Best reviews this information to determine how the captive is structured and operated. This information outlines the number, nature, composition and responsibilities of the various committees, such as underwriting, loss control, investments, accounting, compliance and administration. Any out-sourcing of corporate functions to third parties or the parent will be garnered from the review of policies and procedures. A determina-

tion as to how stringent the underwriting guidelines and loss control procedures are, particularly as respects controlled third-party business, is an important part of Best's analysis.

Financial Size Categories

To further enhance the usefulness of Best's financial strength ratings, A.M. Best assigns a Financial Size Category (FSC) to each company it rates. The FSC is an indicator of the size of a company in terms of its capital, surplus and certain related accounts. Best's Financial Size Category is based on reported capital and surplus plus conditional or technical reserve funds, such as asset valuation reserve, other investment and operating contingency funds and miscellaneous voluntary and required reserves reported as liabilities.

Financial Size Categories (FSC)

| | | |
|----------|--------------|-------|
| FSC I | less than | 1 |
| FSC II | 1 to | 2 |
| FSC III | 2 to | 5 |
| FSC IV | 5 to | 10 |
| FSC V | 10 to | 25 |
| FSC VI | 25 to | 50 |
| FSC VII | 50 to | 100 |
| FSC VIII | 100 to | 250 |
| FSC IX | 250 to | 500 |
| FSC X | 500 to | 750 |
| FSC XI | 750 to | 1,000 |
| FSC XII | 1,000 to | 1,250 |
| FSC XIII | 1,250 to | 1,500 |
| FSC XIV | 1,500 to | 2,000 |
| FSC XV | greater than | 2,000 |

Assigned to all companies and reflects size based on capital, surplus and conditional reserve funds in millions of U.S. dollars, using the scale above.

Single Parent Captive Rating Methodology

Introduction

Although captive insurance subsidiaries are established to serve various needs within non-insurance organizations, they all function as risk bearing entities that operate like commercial insurers. Accordingly, A.M. Best's analysts evaluate a single parent captive in a manner similar to that used with a commercial insurance company, but with consideration given to the financial risk of the corporate-sector parent. A.M. Best applies its own risk evaluation process to the parent and its relationship to its captive. The corporate assessment covers company and industry risks and potential support for or impact on the captive.

The resulting Best's Rating provides an opinion on a captive's ability to meet its obligations. The rating assessment is based on a comprehensive analysis of the organization's balance sheet strength, operating performance and business profile. The process includes a comparison on a quantitative and qualitative basis both with captive peers and commercial peers (if the captive is writing controlled third party business).

A.M. Best is known for the extensive quantitative evaluation it performs on each company assigned a Best's Rating. Its approach to captives is no exception. Analysts review all entities by looking at how they are performing currently and their historical performance. More importantly, this evaluation is used to assess an entity's ability to continue to perform successfully. Companies are evaluated based on their absolute results, as well as their performance levels relative to companies with similar profiles. Variability in annual results or discrepancies relative to similar firms is discussed with management to gain a better understanding of underlying trends and business risks.

The quantitative evaluation focuses on balance sheet strength and operating performance. Balance sheet strength becomes more of a focus in the determination of ratings for captives, since the primary role of many of these entities is to operate as a corporate risk financing and/or strategic tool rather than an independent profit generating operation. An important tool in analyzing capital adequacy is Best's Capital Adequacy Ratio (BCAR), a proprietary model that identifies an insurer's risk-adjusted capital needs. BCAR is largely influenced by the capital required to

support a number of underwriting, investment, interest rate and general business risks.

Nevertheless, A.M. Best also analyzes operating profitability and liquidity to measure the captive's ability to underwrite effectively and pay claims readily.

Quantitative Evaluation

The following are the more important quantitative factors used in the analytical process.

Balance Sheet Strength

Balance sheet strength is the cornerstone of any viable insurance organization. A.M. Best evaluates six general areas in determining a company's financial strength and flexibility.

Capital Structure/Parent Company

A. M. Best's analytical approach to rating captives is to focus first and foremost on the strategic mission of the captive. Rather than examining a captive in isolation, this approach considers the captive and its relationship to its parent company. The nature, physical location and control of the captive's assets, are major components in the determination of the weighting given to the financial strength and flexibility of the parent.

In addition, A.M. Best evaluates the corporate parent's long-term commitment to the captive insurance company, i.e., its willingness to provide capital when needed. A single parent captive can have a great deal of financial flexibility because of its relationship with its parent. However, if a parent is unwilling or unable to provide for its captive or if it consistently constrains capital through stockholder dividends to the point that leverage becomes excessive, the rating assigned will reflect those circumstances. A.M. Best places great emphasis on parental commitment in maintaining the surplus of a single parent captive at prudent levels.

It is paramount that a single parent captive displays a sound level of capitalization to support the level of risk assumed (underwriting, investment and credit) and the volatility of that business. The quality of a captive's capital will determine the weighting applied to the parent company's financial risk and flexibility in the assignment of an appropriate rating to the captive. High quality capital that is generated internally by the captive—at arms length from the parent—will result in a Best's Rating that

is based more on the merits of the captive itself and is less subject to change due to events at the parent company.

As quality of capital decreases and the captive's capital becomes blended with the parent company, the weighting of the parent company's financial risk and flexibility becomes more significant, and the captive's Best's Rating becomes more dependent on the fortunes of the parent company.

Regardless, parent company financial support for an insurance subsidiary is a particularly important rating factor.

Leverage/Capitalization

Leverage, or capitalization, measures the exposure of a captive's surplus to various operating and financial practices. An analysis of a captive's asset and underwriting leverage is very important in assessing its overall capitalization.

Net retained risk to surplus is the most important ratio to be evaluated by Best's analysts as it measures the exposure of a captive's surplus to any single loss or risk. Compared to the traditional insurance market, captives often take higher net positions on the parent's risks.

Comprehensive Analysis

Below are details of key quantitative and qualitative factors that are used by A.M. Best's analysts in the evaluation of a company. Some factors are universally important to all insurance companies, including single parent captives. BCAR, Current Liquidity, Operating Ratio, and Management Experience would be examples of universally important rating factors. The relevant weight given to any one factor within each key component (balance sheet strength, operating performance and business profile), or to any one factor within each key component, varies by rating level and the specifics of the company. The key factors that the committee considered in its rating determination will be communicated clearly by the analysts to the company.

Many of the quantitative rating factors detailed below will appear in the tables included in the company report that supports Best's Rating Opinion. The tables and report format vary by domicile in order to accommodate various statutory and GAAP accounting standards. The tables and reports within a domicile are standardized for ease in comparison of companies. The relative importance of various rating factors and any significant deviations from peer or industry norms are explained fully in the report.

Key Capitalization Tests:

Change in Net Premiums Written.

This ratio measures the company's ability to support controlled business growth from internal capital generation.

Net Premiums Written to Capital and Surplus. This ratio measures the company's exposure to pricing errors in its current book of business.

Net Liabilities to Capital and Surplus. This ratio measures a company's exposures to errors of estimation in its loss reserves and all other liabilities. The higher the loss reserve leverage the more critical a company's solvency depends upon having and maintaining reserve adequacy.

Net Leverage. This ratio measures the combination of a company's net exposure to pricing errors in its current book of business and errors of estimation in its net liabilities after reinsurance, in relation to surplus.

Ceded Reinsurance Leverage. This ratio measures the company's dependence upon the security provided by its reinsurers and its potential exposure to adjustments on such reinsurance.

Gross Leverage. This ratio measures a company's gross exposure to pricing errors in its current book of business and to errors of estimating its liabilities, and exposure to its reinsurers.

Best's Capital Adequacy Ratio (BCAR). This absolute measure compares an insurer's economic surplus position relative to the required capital necessary to support its business risks. Companies deemed

to have "adequate" capital strength generally will generate a BCAR score over 100%; companies deemed to have "excess" capital strength generally generate a BCAR score over 175%. Economic surplus equals reported surplus plus/minus several adjustments. Such modifications include equity adjustments related to unearned premiums, loss reserves, conditional liabilities and assets. Certain off-balance sheet items are also deducted from reported surplus, such as encumbered capital, debt service requirements, potential catastrophe losses and future operating losses. Required capital is calculated as the required level of capital to support seven broad risk categories, including Fixed Income Securities, Equity Securities, Interest Rate, Credit, Loss and LAE Reserves, Net Written Premium and Business Risk. Net required capital represents the arithmetic sum of capital required to support each of the risk categories reduced by a covariance adjustment that recognizes that the risks associated with many of the seven categories are independent and do not occur at the same time.

Key Loss Reserve Tests:

Loss and Loss Adjustment Expense Reserves to Capital and Surplus. This ratio measures the trend and magnitude of loss reserves to

This is appropriate as long as the parent realizes the potential need for additional capital contributions to cover unfunded liabilities in order to maintain a consistent net retained risk to surplus ratio.

A.M. Best also carefully evaluates invested asset leverage, which measures the exposure of a captive company's surplus to investment, interest rate, and credit risk. Investment risk measures the volatility associated with the financial markets and its impact on asset valuations. A.M. Best measures the credit quality of a company's assets.

Underwriting leverage is generated from several sources: current premium writings, reinsurance transactions, and loss or policy reserves. A conservative degree of leverage or capitalization enables a captive to withstand catastrophes, unexpected losses, and adverse changes in underwriting results. It also buffers the captive from fluctuating investment returns as well as changes in regulatory, economic, or competitive conditions. An overly conservative leverage position does come at a cost of potentially lower returns on surplus.

surplus. The higher the multiple of loss reserves to surplus, the more critical reserve adequacy becomes to an insurer's solvency.

Development to Capital and Surplus. This ratio reflects the degree to which year-end surplus was either overstated or understated in each of the past several years.

Development to Net Premiums Earned. This ratio measures whether or not a company's loss reserves are keeping pace with premium growth given a relatively stable book of business.

Key Liquidity Tests:

Quick Liquidity. This ratio measures the proportion of net liabilities covered by cash and investments that can be quickly converted to cash.

Current Liquidity. This ratio measures the proportion of liabilities covered by unencumbered cash and unaffiliated investments.

Overall Liquidity. This ratio measures a company's ability to cover net liabilities with total assets.

Operating Cash Flow. This test measures a company's ability to meet current obligations through the internal generation of funds from insurance operations.

Non-Investment Grade Bonds to Capital and Surplus. This test measures exposure to non-investment grade bonds as a percentage of surplus.

Key Profitability Tests:

Loss Ratio. This ratio measures the company's underlying profitability, or loss experience, on its total book of business.

Expense Ratio. This ratio measures the company's operational efficiency in underwriting its book of business.

Combined Ratio before/after Policyholder Dividends. These ratios measure the company's overall underwriting profitability. A pre-dividend combined ratio of less than 100 indicates the company has had an underwriting profit. A post-dividend combined ratio of 100 or more indicates that the company is returning profits or profits and capital to its parent.

Operating Ratio. This ratio measures a company's ability to generate a profit from its core underwriting and investment activities.

Pretax Return on Revenue. This ratio measures a company's operating profitability.

Yield on Invested Assets. This ratio measures the average return on a company's invested assets before capital gains/losses and income taxes.

Change in Capital and Surplus. This ratio measures the annual change in a company's surplus derived from operations, investments and contributed capital.

Return on Capital and Surplus. This ratio measures a company's effi-

ciency in utilizing its surplus on a total return basis. Total return includes unrealized capital gains.

Key Business Profile Issues:

Spread of Risk. An analysis of a company's risks in terms of geographic and product line diversification is key to understanding its vulnerability to volatility in operating results and surplus.

Revenue Composition. An analysis of investment income and premium volume to determine changes in the amount, type, distribution, diversification and volatility of the assets held and premiums written that might be caused by external changes in the economic, regulatory, legal and financial market environments, as well as by natural and man-made catastrophes.

Management. The experience and depth of management are key determinants for achieving success in the insurance business.

Competitive Market Position. An analysis of an insurer's operating strategy and competitive advantage are essential in assessing a company's ability to respond to market challenges, economic volatility and regulatory change.

Market Risk. Market risk reflects the potential financial volatility that is introduced by, and associated with, the environment in which the company operates.

Quality and Appropriateness of Reinsurance Program

Reinsurance plays an essential role in the spreading of risk and can provide varying degrees of financial stability. A.M. Best will review the appropriateness and creditworthiness of a captive's reinsurance program in light of the captive's mission.

Adequacy of Loss/Policy Reserves

The monitoring of reserve practices becomes an important part of monitoring the solvency of captives. A.M. Best needs to be satisfied that reserves are being reported accurately before having much confidence in the integrity and implications of the financial statements.

Quality and Diversification of Assets.

The quality and diversification of a captive's assets contributes to its financial stability. Therefore, a review of a company's invested assets is performed to assess diversification among industries or geographic regions, with particular attention paid to large single investments. Captives that hold illiquid, undiversified and/or speculative assets and have a significant underwriting exposure are carefully reviewed in light of the greater risks to capital and surplus.

Liquidity

Liquidity measures a company's ability to meet its anticipated short- and long-term obligations to policyholders and other creditors. A captive's liquidity depends upon the degree to which it can satisfy its financial obligations by holding cash and investments that are sound, diversified and liquid, or through operating cash flow. A high degree of liquidity enables a captive to meet unexpected needs for cash, without the untimely sale of investments or fixed assets that could result in substantial realized losses from temporary market conditions

Operating Performance

A captive must demonstrate consistent, positive operating performance, as well as possess strong qualitative factors. A single parent captive should proactively manage its business risks, anticipate market changes and position itself accordingly. Captives that have multiple product capabilities, diversify risk, and respond to the changing needs of their parents, tend to have more stable results and better business profiles than mono-line captives writing in limited geographic areas.

Profitability

A.M. Best reviews the components of a company's earnings to make an evaluation of the sources of profits and the degree and trend of various profitability measures. The areas reviewed include underwriting, investment and total operating earnings, both before and after taxes. A.M. Best realizes that most single parent captives are not designed as significant profit generating operations. The rating process, however, recognizes that all companies have an implied cost of capital — a hurdle rate over which operating returns are necessary to assure future financial strength and, therefore, stability to the policyholder. Several factors, including the nature of a company's risks (i.e. the types and volumes of business written), ownership structure (corporate mission) and overall financial flexibility will affect an organization's cost of capital.

Analysts consider an individual company's performance on absolute terms, as well as relative to the established norms of companies with comparable business profiles and to the expectations of its major stakeholders. Single parent captive insurance companies should generate sufficient operating returns over a

Characteristics of Highly Rated Single Parent Captive Insurance Companies

Quantitative Factors

- Captive is meeting stakeholder expectations. (Mission)
- Parent company flexibility.
- Strong / permanent capital and surplus.
(Held by captive or, if held by parent, captive has ready access)
- Optimal reinsurance program.
- Conservative reserves and appropriate net retentions.
- Appropriately structured investments.
(Traditional or non-traditional, including investment in affiliated companies)
- Sound liquidity.
- Consistent, positive operating performance.

Qualitative Factors

- Committed financial parent company.
- Prudent risk management program.
- Demonstrated interest by parent in captive's activities and performance.
- Multiple lines or specialized and stable product strategy.
- Good geographic spread of risk.
- Ongoing, open dialogue with A. M. Best analysts.

Frequently Asked Questions

Q. Is a Best's Rating on a captive limited by published third-party ratings of the parent?

A. No. Best's Ratings are proprietary and have no set equivalents to third-party ratings. As part of the rating process on a captive, A.M. Best conducts its own analysis of the parent company and does not rely on or use any third-party published ratings. In fact, it does not matter if the parent company has a published rating or not. A.M. Best will require all relevant rating information on the parent company, in addition to that which is specific to the captive. A.M. Best maintains strict confidentiality on any proprietary information provided during the rating process.

A.M. Best's analysis of the parent company primarily focuses on three areas: (1) capitalization (quantity and quality); (2) financial flexibility; and (3) ownership structure. A.M. Best also assesses how the parent company's risk ultimately may affect the captive.

Q. Can a captive receive an A.M. Best financial strength rating higher than the equivalent of a third-party published rating of the parent company?

A. Yes it can. Again, however, Best's Ratings are proprietary and have no set equivalents to any third-party ratings. A Best's Rating is determined independently of any third-party rating of the parent. A.M. Best always will assess the true nature of the relationship between parent and captive, mainly focusing on the captive's strategic mission and its financial reliance on the parent company.

Q. Will a Best's Rating on a captive change if a third-party published rating of its parent company changes?

A. Not necessarily. In the event of a change in the parent compa-

ny's financial position, A.M. Best would go through a complete analysis. Only in those cases where A.M. Best concluded that the change or the reasons for the change impact the financial strength of the captive, would an appropriate change be made in the Best's Rating on the captive. Again, A.M. Best assessments are made independently of any published third-party ratings, or changes to same. As part of the ongoing interactive dialogue between A.M. Best and the companies it rates, a change would be explained to management prior to its release.

Q. Does A.M. Best publish ratings on captive parent companies?

A. No. A.M. Best is the world's premier rating company specializing in the insurance industry.

Nevertheless, A.M. Best has the expertise to assess the financial position and relationship of a parent as it relates to the financial strength rating of the captive. A.M. Best has maintained its position as the preeminent provider of financial information for the global insurance industry by evolving along with the industry and meeting the needs of ever-changing markets. This has included adding skills to complement our analysis on insurance company financial strength. Economists, banking and corporate analysts, and capital market specialists from a wide array of backgrounds are active participants in Best's rating process.

Q. How does A.M. Best view a note receivable from the parent company or loans made by the captive to its parent?

A. A promissory note from the parent, serving as the main source of capital for the captive, results in added weight being given to the parent company's financial position and flexibility in the assignment of

an appropriate rating to the captive. A similar view would be taken if the captive were loaning back its assets to the parent, or the parent's subsidiaries. Such affiliated investments greatly limit the captive's liquidity and economic surplus position and make its future viability intrinsically tied to the financial position of the parent company. The extent of the impact depends on the relative size of the affiliated investments in relation to total investments of the captive.

Q. Will A.M. Best consider letters of credit as capital in the analysis of a captive?

A. Yes. Letters of credit, allowed by regulators to meet capital requirements, are acceptable forms of capital. In addition, off balance sheet items, such as contingent capital, also will be considered in the evaluation of a company's capital adequacy.

Q. Does the lack of an independent actuarial review of loss reserves preclude a captive from getting a Best's Rating?

A. No. A.M. Best recognizes the value of independent actuarial reserve reviews in the analysis of captives.

However, A.M. Best analysts look independently at the reserve position of all companies, utilizing whatever information is available, and make their own assessment as to reserve adequacy.

Q. Are conservative reserves taken into account in calculating the captive's capital adequacy?

A. Yes. A.M. Best's proprietary capital adequacy model (BCAR) adjusts reported surplus to provide a true understanding of a company's economic capital. These adjustments may include some credit for reserve redundancies as well as for voluntary and mandatory contingency reserves.

reasonable period of time to cover their capital needs and inflation-adjusted claim costs. If not, financial strength is likely to deteriorate as a result of a weakening capital base.

Qualitative Evaluation

The qualitative rating process evaluates the positives and negatives of a captive company's operations. The following are some of the more important qualitative factors that are used in the analysis.

Business Profile

Operating Strategy and Business Plans.

These measure the focus and purpose of the captive. A.M. Best analyzes the feasibility of the plans with respect to current market conditions and the support and commitment of the parent organization. A single parent captive must be able to demonstrate continued value added to its parent through effective risk management services, stable pricing, appropriate investment programs, and earnings generation. One well-documented advantage of having a captive company is the ability to mitigate losses because of management's underwriting expertise and niche focus. In addition, a heavy emphasis is placed on loss control and claim management as well as the overall greater familiarity by the captive with the parent's primary business.

Quality and Stability of Management

Captives are evaluated in light of the strength, stability, risk tolerance and experience of management. Prudent risk management and demonstrated interest by the parent company in the captive's activities and performance are important rating factors.

Marketing Strategy and Competitive/Environment

A single parent captive writing controlled third party business should be able to show how it is positioning itself against competition.

Product and Geographic Concentration

A.M. Best will take into consideration the captive's geographic concentration and catastrophic exposures, as well as its ability to expand by providing other coverages or products.

Country Risk

The relatively stability of different country factors are an important element in A.M. Best's rating process. Best views as having minimal country risk those nations with market driven economies, improved standards of living, broad income distribution and a high degree of integration in the global economy.

CURRENT GUIDE TO BEST'S RATINGS

For a complete explanation of Best's Ratings, please refer to the Preface of *Best's Insurance Reports®* or *Best's Key Rating Guide®*. Best's Ratings reflect our independent opinion, but are not a warranty of a company's financial strength and ability to meet its obligations to policyholders.

BEST'S RATINGS AND FINANCIAL PERFORMANCE RATINGS (FPR)

A.M. Best assigns to insurance related organizations one of two types of rating opinions, a Best's Rating (A++ to F) or a Financial Performance Rating (9 to 1). The Best's Rating represents an opinion based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The FPR represents an opinion based primarily on a quantitative evaluation of a company's balance sheet strength and operating performance for companies that do not meet the minimum size and/or operating experience requirements for a Best's Rating.

Secure Best's Ratings

A++ and A+ Superior
 A and A- Excellent
 B++ and B+ Very Good

Vulnerable Best's Ratings

B and B- Fair
 C++ and C+ Marginal
 C and C- Weak
 D Poor

E Under Regulatory Supervision
 F In Liquidation
 S Rating Suspended

Secure FPR Ratings

FPR 9 Very Strong
 FPR 8 and 7 Strong
 FPR 6 and 5 Good

Vulnerable FPR Ratings

FPR 4 Fair
 FPR 3 Marginal
 FPR 2 Weak
 FPR 1 Poor

RATING MODIFIERS and AFFILIATION CODES

Under Review (u) Rating Modifiers are assigned to Best's Ratings and Financial Performance Ratings to identify companies whose rating opinions are Under Review and may be subject to near-term change. Qualified (q) Rating Modifiers may be assigned to Health Maintenance Organizations (HMO's) and Canadian insurers that do not subscribe to our interactive rating process. Best's Qualified Ratings are therefore based primarily on a quantitative analysis of a company's balance sheet strength and operating performance. Best's Public Data (pd) Rating Modifiers may be assigned to UK and other European insurers that do not subscribe to our interactive rating process. Best's Public Data Ratings reflect both qualitative and quantitative analysis using publicly available data and other public information. Syndicate (s) Rating Modifiers are assigned to syndicates operating at Lloyd's. Affiliation Codes are based on a Group (g), Pooling (p) or Reinsurance (r) affiliation with other insurers.

Rating Modifiers

u - Under Review
 q - Qualified
 s - Syndicate
 pd - Public Data

Affiliation Codes

g - Group
 p - Pooled
 r - Reinsured

NOT RATED CATEGORIES (NR)

Companies not assigned a Best's Rating or FPR are assigned to one of five NR categories which identifies the primary reason a rating opinion was not assigned to the company. For additional information, refer to the Preface.

NR-1 Insufficient Data NR-4 Company Request
 NR-2 Insufficient Size and/or Operating Experience NR-5 Not Formally Followed
 NR-3 Rating Procedure Inapplicable

FINANCIAL SIZE CATEGORIES (FSC)

Assigned to all insurance companies and reflects their size based on their capital, surplus and conditional reserve funds in millions of U.S. dollars, using the scale below. For additional information, refer to the Preface.

| | | | |
|-------------------|---------------------|------------------------|---------------------------|
| FSC I less than 1 | FSC V 10 to 25 | FSC IX 250 to 500 | FSC XIII 1,250 to 1,500 |
| FSC II 1 to 2 | FSC VI 25 to 50 | FSC X 500 to 750 | FSC XIV 1,500 to 2,000 |
| FSC III 2 to 5 | FSC VII 50 to 100 | FSC XI 750 to 1,000 | FSC XV greater than 2,000 |
| FSC IV 5 to 10 | FSC VIII 100 to 250 | FSC XII 1,000 to 1,250 | |

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Version 100401

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