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Alternative Risk Transfer (ART)

The purpose of this Alternative Risk Transfer (ART) criteria report is to delineate the rating considerations specific to ART vehicles in the following broad categories: Single-parent (or pure) captives, group captives, Risk Retention Groups, and Self-Insurers Funds. Some ART vehicles operate in a manner similar to a commercial insurer, while others operate in a distinct manner that differs substantially from a commercial insurance carrier. Protected Cell Corporations or “cell captives” are covered under a separate A.M. Best criteria report.

There are three distinct features of ART insurers that are more or less universal to all types of captives: the use and equity treatment of a specific type of letter of credit; the emphasis on capital preservation over operating performance; and the emphasis on business retention over market share. The latter two features are also apparent with many mutual insurers where persistency and surplus accretion are key reasons for their long-standing position in the market.

Treatment of Letters of Credit for ART Entities

Letters of credit (LOCs) take many forms and typically are treated as debt in the rating process, whether for a commercial insurance carrier or for an ART entity (most often a single-parent captive). However, A.M. Best is aware of the use of a particular type of LOC to capitalize an ART entity, and this arrangement is encouraged by a number of captive insurance regulators to assist a regulator in accessing an ART entity’s capital if needed. The details of the LOC must be presented to A.M. Best for capital consideration and determination of equity credit. The LOC generally must have all or most of the following characteristics: stand-alone; irrevocable; evergreen; funded; in favor of the ART entity; and drawn on a highly rated bank. Certain types of LOCs may receive up to 100% capital credit, and that capital credit may not be subject to the usual threshold of 20% of surplus.

By stand-alone, it is meant that the instrument is not part of a credit facility or agreement that may have covenants and terms that can impair the liquidity of the LOC. It should be evergreen and irrevocable, which means that the instrument automatically renews and cannot be canceled except by prior written agreement by all parties. It should be funded with assets on deposit with the bank from which the LOC is drawn, and that bank takes the risk if the assets fall short of the face amount. Finally, the LOC should be drawn on a highly rated bank so that the credit risk of the bank does not cause an undue “haircut” of equity credit.

It should be noted that under similar conditions, qualifying New York Regulation 114 trusts can receive equity credit as well.

Capital Preservation and Operating Performance

The ART marketplace was born out of insurance capacity shortages and price volatility of the commercial insurance market



that historically have resulted from the vagaries of the underwriting cycle. ART vehicles invariably have the mission to provide consistent, tailored coverage at stable pricing to policyholder owners. This dynamic results in a focus on capital preservation, with less emphasis on profit and return measures. Rated ART entities generally record solid profitability before policyholder and stockholder dividends. As a result, while ART vehicles may appear to have lower levels of underwriting and net income available to common shareholders, consideration is given in the rating process to return measures both before and after policyholder and owner dividends, depending on the historical use of these dividends.

Market Profile

Most ART entities have a limited market share and therefore a limited market profile compared with many commercial insurers. While market profile is still important in the rating process for any insurer, A.M. Best recognizes the unique nature of the relationship between the ART entity and the insured and its impact on market profile. ART vehicles can be different in that they can have customized coverages, customer-specific claims and loss-control solutions, and board representation from owner insureds. Accordingly, retention ratios for ART vehicles tend to be much higher than those of commercial insurers, averaging more than 90%. ART vehicles gain and retain business by narrow and very specific products that are meant to address specific needs. Historically, the “value added” services such as loss control and engineering, in addition to policyholder dividends, have enabled ART vehicles to hold onto customers even in soft insurance cycles.

Single-Parent (Pure) Captives

Market Profile – Given that the customary definition of market profile of a commercial insurer does not apply to a single-parent captive, A.M. Best looks for signs of how well the single-parent captive is entrenched in the risk management and commercial activities of the parent company’s business. The continuum ranges from the captive being used simply as a risk financing tool, which represents a relatively weak substi-

tute market profile, to being used as the platform from which the parent company’s enterprise risk management program is implemented. A.M. Best will assess the risk management contribution of the captive to the parent company’s business operations in this manner.

Volatility of Operating Results – Since a single-parent captive has a relatively narrow scope of risk, there tend to be periods of very low loss activity contrasted with periods of significant losses. What A.M. Best looks for in these cases of volatility is the parent company’s previous demonstrated support or documented support agreement, which outlines the intent and ability to support the captive with economic resources if needed.

Net Retention to Surplus – Akin to the rating of a commercial writer, an ART rating can be adversely impacted if the company writes a net aggregate per-occurrence limit that is greater than 10% of surplus. This is especially an issue with ART, as the companies often have limited spread of risk and very specific operating plans. For instance, one misinterpretation of building codes can be very problematic to a group captive that specializes in home construction. In the case of a single-parent captive, the probability of the full limit loss is determined, and then financial resources at the captive and the parent company are assessed for their ability to sustain a full limit loss under stress conditions. For instance, if a single-parent captive writes coverage for several properties in one city, the probability of all of these buildings experiencing a full limit loss in any one accident year is considered in assessing the capital adequacy of the captive.

Loan-Backs to the Parent Company – A.M. Best recognizes that there are a number of reasons why a captive would want to make a loan of working capital back to the parent organization. Domicile-approved loan-backs must be documented properly with an arms-length loan agreement. Then the loan-back is charged a risk factor that contemplates the risks associated with the loan. The largest risk is generally the credit risk of the parent company, which is assessed via external (credit ratings) and

internal financial analyses. Other risks may be present in a loan-back situation, such as the strength of the loan-back agreement and the parent company's cash-flow volatility, and the analyst will assess these on an ad hoc basis.

Group Captives

Group captives are ART vehicles that offer insurance to several or many 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 vehicle that most resembles a commercial insurer, and the rating dynamics for a group captive are closer to those of a commercial insurer as well.

Risk Retention Groups

Risk Retention Groups (RRGs) are governed under the Liability Risk Retention Act of 1986, which is a U.S. federal statute, and therefore states' insurance departments have less authority over RRGs than they do over state licensed insurers. This fact makes RRGs distinct in some respects and requires particular attention to the analysis of those differences. The major difference between the rating process of a commercial insurer or group captive and that of a RRG is the treatment of substitute forms of capital, particularly qualifying LOCs and New York Regulation 114 trusts. RRGs are distinct from other types of insurers in that only owners can contribute capital to the group, and only policyholders can be owners. So a managing general agent (MGA) or third-party administrator (TPA) that runs a program utilizing a RRG for writing the liability insurance cannot make a capital contribu-

tion to the organization (MGAs and TPAs don't make contributions to regular commercial insurers). What they can do is sponsor a qualifying LOC to bolster equity capital. A.M. Best can give a substantial percentage equity credit in these situations if conditions warrant consideration. This includes a detailed analysis of the sponsor's long-range intentions.

Self-Insurers Funds

Several U.S. domiciles allow for self-insurers funds as an alternative form of insurance. By definition, these types of ART instruments can write only selected coverages for policyholder owners doing business in that particular state. self-insurers funds have two main differences that set them apart from commercial insurers: joint and several liability for any claims, and being governed under a specific charter where the surplus is wholly composed of Subscribers' Savings Accounts. Joint and several liability requires that all of the Subscribers' Savings Accounts and all of the policyholder owners' assets can be used to satisfy any claims. The joint and several conditions can be compared to an unlimited policy assessment feature. A.M. Best generally gives full equity credit to the Subscribers' Savings Accounts, depending on the specifics of the individual self-insurers' fund. These funds, by statute, distribute all net income to the Subscribers' Savings Accounts, so operating performance for this type of ART entity is evaluated pre-distribution.

Conclusion

While the rating process is substantially the same for ART vehicles as it is for commercial insurers, there are some key differences in the way these vehicles operate that do get reflected in the rating process of these types of entities.

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Methodology

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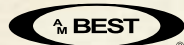
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