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Information Needed to Rate A Protected Cell Captive

The information needed will vary based on the particular business/issue placed in the PCC. However, most PCCs would have to provide at least the following information:

- 1) Audited financials for the PCC and each cell
- 2) Actuarial reports
- 3) Contractual agreements between cells
- 4) Collateral agreements
- 5) Reinsurance agreements
- 6) Cell sponsor/user information

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Rating Protected Cell Companies

The purpose of this special report is to discuss how existing captive rating methodologies or other A.M. Best rating methodologies would apply to the rating analysis of some forms of protected cell companies (PCCs).

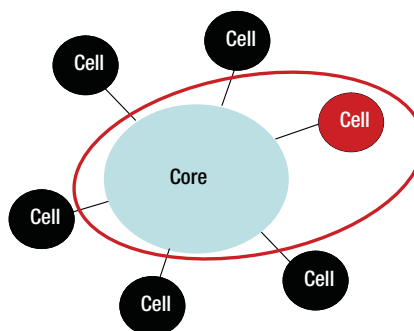
Rating Perspective

The PCC is a highly complex and flexible structure that can be utilized in a great variety of ways by multiple users and sponsors. It is used to hold any number or combination of insurance and financial operations, transactions or instruments. Moreover, the legal and regulatory frameworks that apply to PCCs are not uniform. There are significant differences among domiciles.

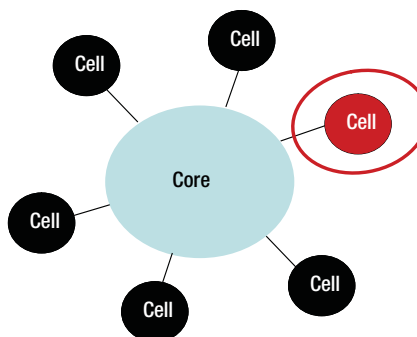
Accordingly, the existing methodologies used by A.M. Best to rate operating companies and debt issues also are applicable to PCCs. For example, the captive rating methodology would apply to a single-parent captive program that is housed in a PCC. Similarly, a sidecar program that utilizes a PCC also would be evaluated in light of A.M. Best's sidecar methodology. A securitization that uses a PCC also would be analyzed based on the existing methodologies for that particular issue.

In the case of a debt issue or securitization, the legal structure utilized may be extraneous, in which case a long-term debt rating might be assigned, and the PCC may not be assigned a financial strength rating (FSR). In the case of an insurance program, however, an FSR and/or issuer credit rating (ICR) actually

Ringfencing in Protected Cell Companies



In some jurisdictions and certain cell company configurations, creditors can claim against the core.



In other jurisdictions, assets of the cell are ringfenced from both the core and other cells.



is assigned to the PCC and/or the individual cells depending on the particular facts and circumstances.

PCC Background

The use of protected cell company captive insurers as a viable alternative risk-transfer mechanism continues to grow in popularity and utility. A number of captive domiciles have specific provisions addressing protected cell companies, how they are to be established, under what rules they are to function and how they are to be treated as legal entities. The terms used to describe the structure vary somewhat depending on the domicile.

For purposes of this report, the generic protected cell company (PCC) will refer to the overall entity, structure or core and comprises one or more cells plus the central core capital not ascribed to any particular cell. Each protected cell within a PCC can represent the insurance business from a specific insured entity; a line of business from an insured company that also has other cells within the PCC; or multiple lines of business from a common parent company but separated by business unit or geographic location. Due to the immense flexibility of the PCC concept, there are and will be numerous variations on the use of protected cell companies.

To date, there has not been a full test in a court of competent jurisdiction of the legality of the walled-off structure between any two or more cells within a cell company. The preponderance of legal opinion on the legislation, however, comes in on the side of the protected nature of each cell. Lingering issues remain that could have an impact on the protected cell movement. These include tax liability matters; insolvencies of sponsoring companies; and run-off situations.

Managers, participants and owners of protected cell company captives use a highly flexible tool to address narrowly focused self-insurance needs. This is in response to market pressures on rates and/or a desire to manage exposures more efficiently and track them more effectively. Achieving a reliable and consistent financial strength rating has

become increasingly imperative as these entities react to intensified demands for accountability, transparency and proof of value added. Each of these organizations and their insureds, as well as regulatory authorities and numerous other interested parties, requires a consistent means to determine the security and operational viability of these risk-transfer vehicles. Through a diligent application of tested analytical tools and processes, Best's Ratings achieve a level of consistency that ensures credibility and comparability. With a financial strength rating, a protected cell or a PCC carries its own, recognized standing in the business world.

A.M. Best Company Methodology

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A.M. Best has been the premier provider of financial information and ratings for the insurance industry for more than 105 years. Relying on this experience, the rating evaluation process has evolved into a thoroughly tested one that incorporates the in-depth analysis of company-specific, quantitative and qualitative factors and industry dynamics as achieved through ongoing, interactive discussions with senior management of the rated organization.

Rating Process

The criteria for obtaining a rating are similar, in most respects, for all insurance entities. A rating assigned to one company means that company has a comparable financial strength to that of any other company with the same rating, regardless of whether they are publicly traded carriers, mutual insurers or captive organizations. In other respects, the rating process does recognize and incorporate the unique characteristics of each insurer, reflecting lines of business written, market position, sources of support, external obligations such as debt load, insured and member composition, management capability and operating

environment. The standards enumerated in this paper are geared to the protected cell company captive insurance market. These are based on the rating methodology applied to single-parent and multi-owner captive insurance companies according to A.M. Best's Rating Methodology for Captive Insurance Companies, which was published in November 2005 and should be referenced in conjunction with this report. Therefore, A.M. Best has adopted a customized approach to rating PCCs. Both the analysis and the assigned ratings are specific to the entity. The analysis depends on the characteristics of the business that is placed in a PCC as well as the structure of the PCC and the domicile. The resulting rating(s) reflect the particular financial strength and creditworthiness of the entity. The rating(s) assigned may be FSRs, ICRs or debt ratings, or any combination of these.

Rating Distinctions Between PCCs and PCs

The protected cell company and protected cell (PCC/PC) option can provide a very focused and viable tool to manage insurance risks within an organization. It offers a means to assume reinsurance

Evolving Structures

The rapid pace of captive formations in recent years has generated much discussion. One area of growth in particular has attracted considerable attention: the protected cell company (PCC). By some accounts, this might be the fastest growing area of the alternative risk transfer (ART) world. This popularity, however, does not reflect a new phenomenon. The PCC actually has been around a long time: formally, for a decade, with the first official formation in 1997 in Guernsey, and informally, much longer. Bermuda created PCCs through private-act legislation in the early 1990s, and rent-a-captives (RAC) have been around since the 1970s. Whereas RACs segregate assets and liabilities contractually, PCCs do so legislatively. As such, the PCC may be viewed simply as a variation or the result of an evolution of the original RACs. In addition, as the PCC may house not only an insurance program but also an investment fund arrangement or a financial transaction such as a securitization, it may be considered a special-purpose vehicle (SPV) or multi-use corporate entity. Regardless, other legal structures in the alternative risk transfer (ART) world have been developed over the years besides

the PCC, and the innovation continues. (See "From RACs to SACs" sidebar.)

The development of legal arrangements allowing segregation of assets and obligations is the result of many factors. The risk management community continuously needs to respond to the dynamic changes whereby risk exposures grow or diminish relative to others as economic, political and social circumstances develop. Concurrently, the ability (and willingness) of risk takers such as commercial insurers to respond to the needs of the risk management community shifts sporadically and may not be available in a timely fashion. This leads to brokers, (re)insurers and bankers continuously searching for and developing innovative solutions and improvements to existing options. At the same time, new and competing domiciles are trying to attract and retain business, while the appetite of sophisticated investors for insurance-related investments expands. The increasing flow of information and capital and the globalization of markets also facilitate innovation. Undoubtedly, the legal engineering and enabling legislation of captive structures such as the RAC or SPV will continue.

from a fronting carrier and to isolate certain exposures from a more broad-based risk-financing program. A protected cell also offers a smaller insured an entry into alternative risk transfer options that may be more cost effective than establishing a fully licensed captive insurer. This has the further benefit of giving the insured

better control of its risks and their financing and gives it the experience needed should it wish to move to a pure captive in the future.

Evaluating the financial strength of a protected cell or protected cell company requires a clear understanding of the program's ability to handle the exposures of its sponsoring organization. If the insured organization establishes its own PCC and subdivides its risks into a number of protected cells (PCs) within the PCC, then for all practical purposes it will be treated like a pure captive insurer for rating purposes. Also, if a cell has financial flexibility to access additional funding from its sponsoring organization, this option would be treated on terms equivalent with that of a pure captive operation and can be rated in a comparable fashion.

On the other hand, if an organization places its risks into protected cells that either have no access to additional funding and/or are under the umbrella of another entity's PCC, or core, then that PC must be reviewed carefully to ensure that the anticipated protection will exist should it be needed. It is important to know the quantity of risk transferred to the cell, based on both expected and worst-case scenarios. The generally smaller size and limited scope of individual PCs make stress testing for various adverse scenarios more important, particularly if financial flexibility is limited. Nonetheless, due to the flexibility allowed in the contractual arrangements in establishing a PC, mechanisms can be incorporated to allow for various means to either fund the cell adequately up front for all reasonable circumstances, or to have access to on-demand additional funding from the PCC or from the owner of the cell.

There are some significant differences between rating a protected cell and rating a PCC organization in totality. For a PC, the mechanism will be somewhat comparable to the process of assigning a financial strength rating to any other type of insurance entity, including captive insurers. The analytical team will examine the PC's financial condition, its risk profile, its actuarially determined loss and IBNR reserves, and the credit exposures it has accumulated. In addition, its contractual relationships

From RACs to SACs

There are a variety of terms used in reference to protected cell companies and similar structures. With more than 30 different domiciles having promulgated PCC legislation and with the differences among the laws, the multiplicity of terms is not surprising. In addition, the protected cell company may be viewed simply as a variation of the rent-a-captive structure or even a special-purpose vehicle. There also are several other legal structures that have similarities to the PCC. Hence, the multitude of terms, structures and perspectives may cause confusion, even for the experienced ART practitioner. Below are some of the terms and acronyms used:

PCC Structures:

The following list of names and acronyms includes examples of the terminology utilized by various domiciles to refer to actual PCCs.

Incorporated Cell Captive (ICC) (e.g., used in Jersey)

Protected Cell Company (PCC) (e.g., used in many U.S. state domiciles)

Segregated Accounts Company (SAC) (e.g., used in Bermuda)

Segregated Portfolio Company (SPC) (e.g., used in Cayman)

Sponsored Captive Insurance Company (SCIC) (e.g., used in Vermont)

Other Structures:

Producer Owned Reinsurance Company (PORC) – Captive reinsurance entity established to provide reinsurance for a producer's business.

Rent-a-Captive (RAC) – (Re)insurance entity that rents its capital, surplus and license to clients and provides administrative services. Clients' business is separated by accounting and contractual means.

Special-Purpose Vehicle (SPV) – Corporate entity created to enable a specific business transaction and fulfill a narrow objective.

Special-Purpose Financial Captive (SPFC) – Corporate entity created for the securitization of insurance risk. It may establish protected cells.

with other protected cells, if any, and with the core PCC will be reviewed thoroughly. Financial flexibility and the adequacy of the PC's capital relative to the risks assumed are the critical factors in this analysis.

Assuming that designated, individual protected cells exclusively bear all the risks placed with a PCC organization, and that the PCC core does not take any of these underwriting risks, then the analysis will focus on the likelihood of the PCC's own capital base being eroded from any contractual relationships it has with the member PCs. This could take the form of capital maintenance guarantees, stop-loss agreements or similar arrangements with the PCs. Here too, the contracts need to be examined carefully to determine the extent of these liabilities, as well as the potential for attachment of funds by a regulator or a court of law in the case of any member PC becoming insolvent. In these cases, a financial evaluation of all PCs, which could have a potential material impact on the PCC, needs to be conducted, regardless of whether those PCs are rated individually or not, and the aggregate exposure to the PCC must be compared with the PCC's resources to respond to those needs.

Control and monitoring of any protected cell captive program is crucial to ensure

that the expectations for response to claim incidents will be met, given the capabilities and limitations of the cell captive. There are certain overriding themes and issues that will have an impact on the utility of such a program for the insured and on the financial strength associated with it. Fronting and reinsurance agreements will be examined in detail to determine whether the protected cell program will be impacted adversely by the provisions contained in those agreements. Other important considerations include the type of protected cell that is employed, whether open, closed or some variation in between; the contractual relationships among the cells in the program and between them and the core; and the ability of each cell to absorb shock losses or adverse development. Finally, as all domiciles offering venues for protected cells have some variations among their enabling legislative and regulatory provisions and their enforcement mechanisms, the regulatory framework under which the protected cell company and the PCs are established will be evaluated and monitored.

NOTE: A financial strength rating on a PCC does not automatically extend to the individual PCs within the protected cell company structure.



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