

January 30, 2012

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

Additional Information

Criteria:

Alternative Risk Transfer

2011 Special Report:

U.S. Captive Insurance –
Market Review

Analytical Contact

Steven M. Chirico, CPA, Oldwick
+1 (908) 439-2200 Ext. 5087
Steven.Chirico@ambest.com

A.M. Best will consider feedback from any interested party prior to publishing its methodology. Written comments can be submitted by e-mail to methodology.commentary@ambest.com, no later than March 1, 2012.

This methodology is available at
www.ambest.com/ratings/methodology

Draft: Rating Protected Cell Companies

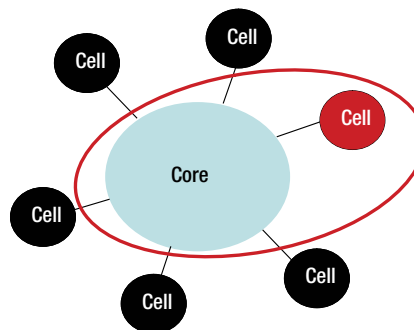
The protected cell company (PCC) is a highly complex and flexible structure that can be utilized in a variety of ways by multiple users and sponsors. It is used to hold any number or combination of insurance and financial operations, transactions or instruments.

Accordingly, the existing criteria used by A.M. Best to rate operating companies and debt issues also are applicable to PCCs. For example, *Alternative Risk Transfer* would apply to a single-parent captive program that is housed in a PCC.

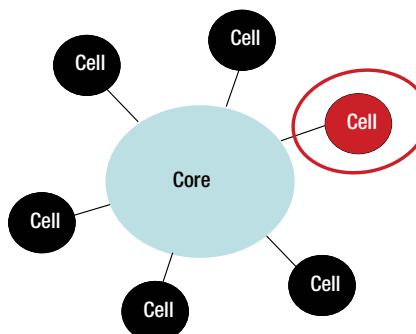
Evaluating the financial strength of a protected cell or protected cell company requires a clear understanding of the characteristics of the business that is placed in a PCC, the structure of the PCC, the domicile and the program's ability to handle the exposures of its sponsoring organization. If the 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

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.

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.

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

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.

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.

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.

Published by A.M. Best Company

Methodology

CHAIRMAN & PRESIDENT Arthur Snyder III

EXECUTIVE VICE PRESIDENT Larry G. Mayewski

EXECUTIVE VICE PRESIDENT Paul C. Tinnirello

**SENIOR VICE PRESIDENTS Manfred Nowacki, Matthew Mosher,
Rita L. Tedesco, Karen B. Heine**

**A.M. BEST COMPANY
WORLD HEADQUARTERS**
Ambest Road, Oldwick, N.J. 08858
Phone: +1 (908) 439-2200

NEWS BUREAU
830 National Press Building
529 14th Street N.W., Washington, D.C. 20045
Phone: +1 (202) 347-3090

**A.M. BEST EUROPE RATING SERVICES LTD.
A.M. BEST EUROPE INFORMATION SERVICES LTD.**
12 Arthur Street, 6th Floor, London, UK EC4R 9AB
Phone: +44 (0)20 7626-6264

A.M. BEST ASIA-PACIFIC LTD.
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827-3400



Copyright © 2012 by A.M. Best Company, Inc., Ambest Road, Oldwick, New Jersey 08858. ALL RIGHTS RESERVED. No part of this report or document may be distributed in any electronic form or by any means, or stored in a database or retrieval system, without the prior written permission of the A.M. Best Company. For additional details, see Terms of Use available at the A.M. Best Company Web site www.ambest.com.

Any and all ratings, opinions and information contained herein are provided "as is," without any expressed or implied warranty. A rating may be changed, suspended or withdrawn at any time for any reason at the sole discretion of A.M. Best.

A Best's Financial Strength Rating – Insurer is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile. The Financial Strength Rating opinion addresses the relative ability of an insurer to meet its ongoing insurance policy and contract obligations. These ratings are not a warranty of an insurer's current or future ability to meet contractual obligations. The rating is not assigned to specific insurance policies or contracts and does not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. A Financial Strength Rating is not a recommendation to purchase, hold or terminate any insurance policy, contract or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser.

A Best's Debt/Issuer Credit Rating is an opinion regarding the relative future credit risk of an entity, a credit commitment or a debt or debt-like security. It is based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance and business profile and, where appropriate, the specific nature and details of a rated debt security. Credit risk is the risk that an entity may not meet its contractual, financial obligations as they come due. These credit ratings do not address any other risk, including but not limited to liquidity risk, market value risk or price volatility of rated securities. The rating is not a recommendation to buy, sell or hold any securities, insurance policies, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

In arriving at a rating decision, A.M. Best relies on third-party audited financial data and/or other information provided to it. While this information is believed to be reliable, A.M. Best does not independently verify the accuracy or reliability of the information.

A.M. Best does not offer consulting or advisory services. A.M. Best is not an Investment Adviser and does not offer investment advice of any kind, nor does the company or its Rating Analysts offer any form of structuring or financial advice. A.M. Best does not sell securities. A.M. Best is compensated for its interactive rating services. These rating fees can vary from US\$ 5,000 to US\$ 500,000. In addition, A.M. Best may receive compensation from rated entities for non-rating related services or products offered.

A.M. Best's special reports and any associated spreadsheet data are available, free of charge, to all *BestWeek* subscribers. On those reports, nonsubscribers can access an excerpt and purchase the full report and spreadsheet data. Special reports are available through our Web site at www.ambest.com/research or by calling Customer Service at (908) 439-2200, ext. 5742. Some special reports are offered to the general public at no cost.

For press inquiries or to contact the authors, please contact James Peavy at (908) 439-2200, ext. 5644.

SR-2008-M-002a