

Rating Sidecars

Overview:

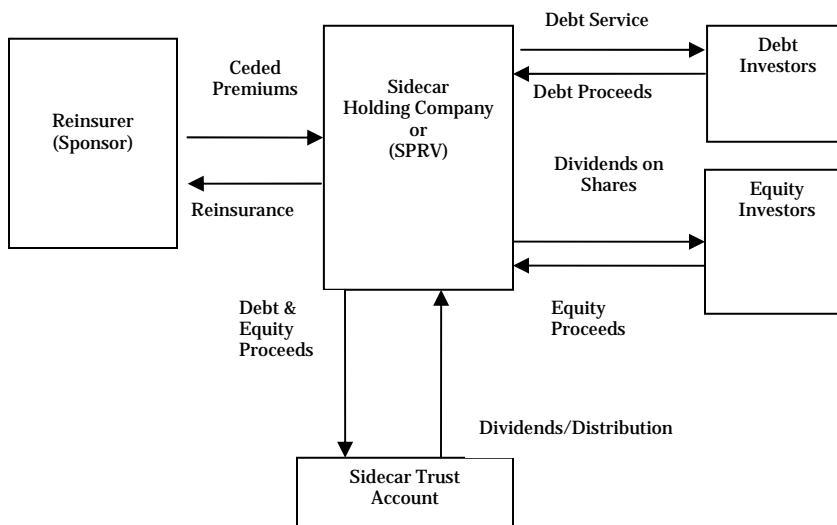
The tightening of reinsurance capacity in the property and casualty market has made the use of "sidecars" an attractive alternative to traditional retrocession. A sidecar is a limited-life special purpose entity that generally provides property catastrophe quota-share reinsurance exclusively to its sponsor. There have been a few life/health-related sidecars but the vehicles are used predominately by property and casualty reinsurers. Of late, A.M. Best has seen an increase in the use of sidecars as a way to offer rated debt to investors seeking exposure to various layers of catastrophic risks.

In the past, A.M. Best has evaluated the capacity and general creditworthiness of sidecars to determine, in general, whether sidecars will strengthen, weaken, or have no effect on the financial strength ratings of the sponsoring reinsurers. The analysis focused on the structural integrity of the transactions and the analytical rigor applied by various experts and advisors, such as peril modelers and investment banks. However, A.M. Best will now go one step further to publish Issuer Credit Ratings and/or debt ratings, where appropriate, on all sidecars and their corresponding debt (if any). This quick reference provides A.M. Best's rating methodology for property and casualty sidecars.

Rating Assigned:

The ratings assigned are as follows: 1) Best's Long-Term Issuer Credit Rating (ICR), which is an opinion as to an issuer's ability to meet its ongoing senior financial obligations and; if debt has been issued by the sidecar, 2) Best's Long-Term Debt Rating, which is an opinion as to the issuer's ability to meet its ongoing financial obligations to security holders when due.

Simplified Sidecar Diagram:





Key Rating Factors:

In general, A.M. Best's sidecar rating methodology takes into consideration the risk characteristics of the underlying perils covered (as reflected in attachment probabilities), the reviews of the financial models used, and the results of stresses on key modeling parameters. A list of some of the items reviewed, evaluated or monitored include the following:

- Sidecar Sponsor – the track record of the sponsor is of utmost importance in determining the viability of the sidecar;
- Data Quality – the level of data quality is critical to the evaluation of the sidecar;
- Terms and Conditions – covenants in the quota share agreement or other underwriting agreements will help determine if the interests of the sidecar investors and the sponsoring reinsurer are aligned;
- Indemnifications & Carve-Outs – the risks that are retained by the sponsoring company must be fully described;
- Documents – structural, regulatory, legal and all third-party related documentation are reviewed although A.M. Best relies on the sponsor's advisors for proper interpretation of such documents;
- Collateralization – the level and form of the collateral, including investment guidelines and the conditions for release of the collateral;
- Ongoing Risk Monitoring – the mechanism by which ongoing risk monitoring will occur, thereby ensuring that A.M. Best can re-evaluate the credit risk of the sidecar on a timely basis;
- Management of Aggregate Risks – includes evaluating the correlation of risk layers;
- Degree of Peril Modeler Involvement – A.M. Best has become aware that involvement of established peril modelers can range from simply making sure that the sponsors turn on the "right levers" on licensed software to actually modeling the peril and verifying data quality. Obviously, A.M. Best will have more confidence in transactions that are independently modeled (with data verification) than those that are all modeled in-house with little or no input from third party peril modelers. Transactions modeled in-house with the watchful eyes of independent reinsurance brokers who are experienced users of the various peril models are viewed positively by A.M. Best;
- Risk Analysis – exceedence probability curves, probability of attachment and exhaustion points should be provided. A.M. Best will ask for base and stressed exceedence probability curves;
- Reserves – the procedures for the establishment and liquidation (run-off) of reserves;
- Key Assumptions on Business Profitability – specific assumptions used in modeling premiums and loss ratios earned/experienced by the sidecar, including assumed volatility of such premiums and loss ratios, are critical.
- Cash Flow Model – review of the cash flow model;
- Business Origination – the projected business origination (including breakout of retrocession business) and how monitoring will take place in order to alert A.M. Best of deviation from plan;
- Protected Cell Structure Mechanics – if the sidecar has a protected cell structure, a discussion of the structure and the limits of each cell including whether each cell truly operates independently with its own capital to absorb losses up to predefined limits. Perils covered in individual cell structures are stressed more than those wholly contained in dedicated special purpose reinsurance vehicles;
- Operational Risks – the monitoring and record keeping needed to maintain the legal separation of the sidecar from the sponsoring insurance company;
- Advisors – particularly tax and legal advisors; and
- Reporting Requirements – financial statements, procedures for reporting material events and exposure information.



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The Assignment of a Rating:

The rating assigned to catastrophe-linked bonds or structures is based on insurance data gathered over 28 one-year periods from December 31, 1977 to December 31, 2005. In this period, over 5,000 U.S. domestic insurance companies (composed of approximately 3,000 P/C companies and 2,000 L/H companies) had at least one A.M. Best financial strength rating, of which 651 became financially impaired. The data is the basis of *Best's Idealized Default Matrix* which A.M. Best uses as a general guideline for assigning ratings on insurance-related bonds or structures. The matrix shows that for each debt rating, there is an associated cumulative default risk corresponding to the term of the debt being rated. As an example of how the table is used, assume that the annual attachment probability of a bond issued by a sidecar is 50.3 bps for a three-year risk period. The cumulative attachment probability would be approximately 1.51% ($3 * 50.3 \text{ bps} = 1.51\%$). Absent any other considerations (and stress scenarios on the modeling parameters) the bond would merit a rating of "bbb-" which is the rating derived from the intersection of the third year line in the matrix below and the 1.51% default probability. Other considerations that may come into play in rating either a sidecar or its debt may include: the level of comfort A.M. Best has with the modeling of the peril, the stress on the attachment points (via the increase in peril frequency), stresses on loss ratios (depending on whether catastrophe or working layer risks are being evaluated), the concept of "credit cliffs" with respect to catastrophe-linked securities or entities, zonal and leverage risk limits, and other factors.

BEST'S IDEALIZED DEFAULT MATRIX												
Yr.	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b
1	0.05%	0.06%	0.11%	0.16%	0.21%	0.23%	0.27%	0.52%	0.66%	0.81%	1.07%	1.33%
2	0.23%	0.32%	0.44%	0.56%	0.67%	0.74%	0.89%	1.51%	1.81%	2.10%	2.83%	3.56%
3	0.42%	0.58%	0.76%	0.95%	1.13%	1.25%	1.51%	2.48%	2.91%	3.35%	4.51%	5.66%
4	0.62%	0.84%	1.08%	1.33%	1.58%	1.76%	2.13%	3.41%	3.99%	4.57%	6.11%	7.66%
5	0.84%	1.10%	1.41%	1.71%	2.02%	2.25%	2.75%	4.30%	5.03%	5.75%	7.65%	9.54%
	aa-	a+	a	a-	bbb+	bbb	bbb-	bb+	bb	bb-	b+	b

Related Reading:

[A.M. Best States Position on Sidecars](#) (Press Release: June 16, 2006), [A.M. Best States Position on Insurance-Linked Securitizations/Monetizations](#) (Press Release: April 24, 2006), [A.M. Best's Idealized Default Matrix](#) (October, 18, 2004), [Best's Impairment Rate and Rating Transition Study -1977 to 2005](#) (March 31, 2006), and [Best's Ratings & the Treatment of Debt](#) (October, 11, 2004).

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