A.M. Best’s sole focus on the insurance industry for more than 100 years has made us the global leader in providing credit ratings of insurers, reinsurers and other risk-bearing entities; the captive market is no exception. With over 200 captive ratings worldwide, we continue to see a significant increase in captive rating inquiries (including Risk Retention Groups [RRGs] and Protected Cells) as well as rating coverage. Based on market trends and regulatory requirements, we expect that growth to continue.

A.M. Best remains committed to providing information, education, analysis and market commentary to the industry. As part of that commitment, we’ve developed this booklet, which encapsulates pertinent and timely information about A.M. Best’s activity in the global captive sector. For the purposes of this booklet, when we use the term “captive,” we refer to the many vehicles within Alternative Risk Transfer (ART): Captives, RRGs and Protected Cells, to name a few.

This booklet is a compilation of material designed to help you better understand A.M. Best’s global focus on insurance ratings and the alternative risk market segment. It includes analytical commentary and research on the captives market, as well as various key topics that demonstrate trends among rated captives, drivers of captive ratings and A.M. Best’s approach to rating captives.

Thank you for your interest in A.M. Best and the services we provide to the global captive sector.

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A.M. Best at a Glance

A.M. Best is a leading provider of ratings, news and financial data with specialized focus on the worldwide insurance industry. Best’s Credit Ratings are recognized as the benchmark for assessing the financial strength of insurance-related organizations and the credit quality of their obligations.

- Established in the U.S. in 1899 and pioneered the concept of financial strength ratings in 1906
- Worldwide headquarters in New Jersey, U.S.; regional centers in London (serving Europe, Middle East and Africa), Hong Kong and Singapore (serving Asia Pacific and Oceania), and Mexico City(serving Latin America). Representative office located in Dubai (serving MENA, South & Central Asia)
- Full-service global ratings capabilities
- Over 3,500 ratings in approximately 80 countries worldwide
- Extensive marketing and publishing capability to promote corporate ratings in local and international markets

Market Coverage

Insurance-related companies operating in various markets, including:

- Property/casualty (non-life) insurers
- Life insurers and annuity writers
- Health insurers
- Reinsurers
- Mutual insurers and Protection & Indemnity (P&I) clubs
- Takaful, Retakaful and co-operative insurers
- Lloyd’s and its syndicates
- New company formations (“start-ups”)
- Alternative risk transfer (ART) vehicles (including captives, pools, risk-retention groups and protected cells)
- Catastrophe bond issuers and other Insurance-Linked Securitizations (ILS)

Competitive Strengths

- Only international rating agency dedicated to the insurance industry
- World’s leading provider of insurer Financial Strength Ratings (FSRs) by company coverage
- Foremost rating coverage of the global reinsurance segment
- Leading position in international (re)insurance hubs—including comprehensive coverage of Lloyd’s/London market, Bermuda, Zurich, Singapore
- Leading rating agency for (re)insurance in the emerging markets of MENA and South and Central Asia.
- Leading rating agency for ART (captives) coverage
- Key rating agency used by global broker security teams
- Data and research covering 16,000 (re)insurance companies worldwide
- Largest and most comprehensive insurance database providing unique insights by segment and line of business
- Published rating methodology on all key insurance industry segments

Research & News

- Publishers of frequent specialized reports on global insurance industry issues, including sector, company and geographic regional analysis. Extensive global insurance news delivery and resources
A.M. Best’s Credit Ratings:
The Global Symbol of Financial Strength

Rating Definitions
Best’s Financial Strength Rating (FSR) An independent opinion of an insurer’s financial strength and ability to meet its ongoing insurance policy and contract obligations.

Best’s Issuer Credit Rating (ICR) An independent opinion of an entity’s ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best’s Issue Rating (IR) An independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis.

Best’s National Scale Rating (NSR) A relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global Issuer Credit Rating (ICR) using a transition chart.

A rating by A.M. Best is based on a comprehensive evaluation of an insurance company’s financial strength, operating performance and business profile. A.M. Best also regularly publishes Impairment Studies, which evaluate rating performance over time.

Best’s Credit Rating Scales
Comparison of Financial Strength Rating (FSR) to Credit Market Scale

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FSR = Financial Strength Rating
ICR = Issuer Credit Rating

E = Under regulatory supervision
F = In liquidation

Note: e/E, f/F and d are non-rating designation status. e/E and f/F are used for insurers, while d is used for non-insurers and securities.

Source: A.M. Best Co.

BestMark for Secure-Rated Insurers
The BestMark provides a recognizable visual symbol of an insurer’s financial strength.

The value of a Best’s Credit Rating is enhanced by market penetration. Best’s Credit Ratings reach:

- More than 150,000 insurance industry professionals via A.M. Best’s publications (BestWeek®, Best’s Review®, BestDay®, BestWire®)
- Thousands of financial professionals worldwide via news vendors such as Reuters, Dow Jones and NewsEdge
- More than 1,400,000 professionals who have registered to gain access to Best’s Credit Ratings online

Best’s Credit Ratings and related financial information provide powerful tools for insurance decision making and market research for insurance agents, brokers, risk managers, bankers, insurance executives, policyholders and consumers.
Breakdown by Captive Type

- Single Parent: 37%
- Group: 34%
- RRGs: 21%
- Exchanges: 4%
- Cell: 2%
- Self Insurance Funds: 2%

A.M. Best Global Captive Rating Coverage
Breakdown by Captive Type

- Cell: 2%
- Exchanges: 4%
- Single Parent: 37%
- Group: 34%
- RRGs: 21%
- Self Insurance Funds: 2%

AMB Regional Captive Rating Coverage

- North America: 72%
- Caribbean & Latin America: 18%
- Western Europe: 5%
- Oceania: 2%
- Asia: 2%
- Eastern Europe: 1%
About Captive Ratings

The alternative risk-transfer market has experienced significant global expansion over the past 30 years, as sophisticated insurance buyers have become increasingly aware of the coverage and cost advantages in bypassing traditional insurance channels for their property, casualty and even some life and health risks. This applies not only to corporations but to insureds forming or joining group captives, risk-retention groups or protected cell companies.

The world looks to A.M. Best for objective financial analysis of insurance companies. In recognition of the growing size of the alternative market, A.M. Best has dedicated a team of experienced analysts focused on assigning Best’s Credit Ratings to captives, risk-retention groups, self-insurance pools and trusts, large-capacity facilities, and protected cell companies.

Best’s Credit Ratings reflect a clear, concise and timely opinion of an insurer’s financial security and ability to meet its obligations in the future. Each Best’s Credit Rating is based on a comprehensive evaluation of a company’s financial strength, operating performance and business profile. Management of rated companies meets and interacts with A.M. Best’s experienced analysts on a cooperative basis and must satisfy a comprehensive review, including requests for supplemental financial and operational information.

We are the global leader in captive ratings, with significant coverage in North America, Bermuda and the Caribbean, and expanding coverage in Europe and the Far East. Through a diligent application of tested analytical tools and processes, Best’s Credit Ratings achieve a level of consistency that ensures credibility and comparability. With a Financial Strength Rating, the captive carries its own recognized standing in the business world.

The Value of a Best’s Credit Rating in the Alternative Market

- A Best Credit Rating may enhance access to reinsurance.
- A Best Credit Rating may help association captives or risk-retention groups attract and retain members.
- A Best’s Credit Rating may provide greater flexibility regarding fronting arrangements.
- A.M. Best’s rating process considers a company’s performance against industry and peer composite standards.
- For those captives seeking the potential benefits of adding the diversification of third-party business, a Best’s Credit Rating can provide a marketing platform.

For more information, visit Best’s Captive Center at www.ambest.com/captive.
A.M. Best’s Rating Process

An A.M. Best Business/Market Development Manager can help get you started by answering your questions and supplying the information necessary to make an informed decision about obtaining a Best’s Credit Rating.

Upon determination of rating feasibility, a rating fee will be quoted. If accepted, a contract will be issued for signature, and when returned, and fee paid, the company will be assigned a rating analyst for the process to begin.

The Rating Process, Step by Step

**Preliminary Discussions on Rating Objectives, Benefits and Scope of Analysis:**
Discussions resulting in the company requesting to enter the rating process.

**STEP 1: Rating Engagement and Contract:**
Once a contract is signed and returned, the company is assigned a rating analyst, and the interactive rating process commences.

**STEP 2: Compiling Information:**
The rating assessment begins with the compilation of detailed public and proprietary financial information, including annual and quarterly financial statements, regulatory filings, certified actuarial and loss-reserve reports, investment detail and guidelines, reinsurance transactions, annual business plans and Best’s Supplemental Rating Questionnaire.

**STEP 3: Rating Management Meeting:**
A.M. Best analysts meet with senior management and technical staff of the company that has applied for a rating (typically in the applicant company’s head office).

**STEP 4: A.M. Best’s Analysis and Decision:**
A rating recommendation is arrived at from the analysis and is taken to the Rating Committee for review and final determination.

**STEP 5: Rating Communication and Dissemination:**
- The rating is communicated to the rated entity.
- Once the rating is accepted by the rated entity, it is published immediately.

**STEP 6: Monitoring Best’s Credit Rating:**
- The company is continuously monitored after the rating has been accepted.
- Open dialogue with A.M. Best’s analytical team is fundamental for the ongoing maintenance of the company’s rating, which will be formally reviewed, at least annually.

The typical duration of the rating process from signed contracts to announcement of assigned ratings is approximately three to four months.
Preparing for a Rating Meeting

Meeting with the management of a company is an integral part of A.M. Best’s interactive rating process. Management meetings enable our rating analysts to review factors that may affect the company’s rating, including strategic goals, financial objectives and management practices.

It is during these interactive meetings that a company typically will share information that may be extremely sensitive or proprietary in nature. As a rating meeting is a critical component in A.M. Best’s analytical process, adequate preparation by the company is imperative. During rating meetings, companies should be prepared to provide and discuss, in detail, a broad range of information that can vary depending on the company and the industry in which they operate. The A.M. Best analyst typically provides a meeting agenda, outlining discussion topics that will guide the preparation effort.

Information Requirements

The primary source of the information is each company’s annual and quarterly (if available) financial statements, as filed with the regulatory agency of the state, province or country in which the company is domiciled.

For a company new to the process, it is important to go through the history and business review issues, as well as the operating performance and overall capital position. For companies that are more familiar with the process, it is more important to focus on changes that have occurred since the last meeting. When there is a transaction pending or significant change in operating strategy and business plan, the focus of the meeting will be on such items.

A.M. Best expects all information submitted by a company to be accurate and complete. Furthermore, A.M. Best expects that any information relevant to the rating process will be submitted on a timely basis.

Key executives should be present to discuss their areas of responsibility, including strategy, distribution, underwriting, reserving, investments, claims and overall financial results and projections. Depending on the size of the company, this can involve anywhere from one to six individuals.

Companies are encouraged to select a rating agency liaison that knows the company well and can respond to ongoing inquiries promptly. This is particularly important with significant events or transactions for which a company should provide advance notification, giving A.M. Best an opportunity to evaluate the effects of the transaction on the company’s operations.

A.M. Best analysts are held to the highest standards of ethical and professional conduct in handling proprietary information. A.M. Best has established policies and procedures to prevent unauthorized disclosure of confidential information and ratings prior to release and allows the use of such information only for purposes related to its rating activities or in accordance with any confidentiality agreements with the rated company.

Four Key Elements

Key elements to maintaining a mutually successful relationship with A.M. Best are:

1. Honest and open dialogue. Your rating agency liaison must have extensive knowledge about your company and be able to manage the relationship with A.M. Best in a productive manner. Discussions concerning your company’s positives and negatives should always be frank. Expect the same from A.M. Best.

2. Full and timely disclosure of company information and plans. This includes your company’s vision, mission and strategy, as well as financial statements and projections, rationales and details of any transactions and sales results.

3. Full preparation for rating meetings. Be prepared to discuss, in detail, topics including corporate overview, strategic plan, business lines, financial overview, investments, operations and technology. All information should be disseminated for review prior to the meeting. For any meeting to be successful, your key executives must be present and be prepared for the discussion.

4. Advance notification of significant transactions. Advance notification, including background information, of significant transactions should be provided. This gives A.M. Best analysts an opportunity to evaluate the effects of the transaction on your company’s operations before reacting to public inquiries. All such information is considered proprietary and will be held in the strictest confidence by A.M. Best.
Global Property/Casualty Captives: Data Requirements

1. Annual Reports – Latest Five Years, then annually including quarterly financial filings. If the Captive has recently been established, Loss Experience and Premiums from Previous Carriers is necessary.

2. Audited Financial Statements for Parent and Subsidiary Companies (Annually)

3. Full Actuarial Reports, When Available (Annually)

4. Corporate Structure/Organizational Chart and History (Initially and as Changed)

5. Objective of the captive along with operating plan and how the captive complements the risk management strategy of the owner/sponsor

6. Management Structure and Key Executive Committees (Initially and as Changed)

7. Biographical Information on Principal Officers and Board Members (Initially and as Changed)

8. List of third party service providers with detail on the scope of the services, brief history of the relationship and length of time remaining on the contract.


10. Five-Year Projections (Annually as Changed)

11. Capital Management Strategies including detail on asset loan back arrangements and letters of credit issued from the parent to the captive, if applicable.

12. Estimated Impact (Net and Gross) from Catastrophe or Other Unusual Event

13. Risk Management Program including the estimated impact (net and gross) from a catastrophic loss.


15. Reinsurance Program/Reinsurance Contracts

16. Completed Best’s Supplemental Rating Questionnaire (Annually)

17. Fronting Information – Copy of Fronting Policy/Contract Including:
   - Name of the fronting company, length of policy, policy renewal details, limits, terms and conditions, exclusion and a summary of what hazards are covered.
   - Collateral or Security Requirements of the Fronting carrier.
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 substitute 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 state’s 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 contribution 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.
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 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 underlying 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

### 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
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.

**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.

**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.
Rating New Company Formations

Regulatory and tax issues, as well as market dislocations and consumer demand for new and innovative products and services, continue to influence new insurance and reinsurance company formations. As a result, brokers, agents, lenders, capital market participants and corporate clients continually seek financial information about new entities as they are formed. To meet this demand, A.M. Best Co. provides ratings on new organizations and other risk-assuming vehicles using methodology outlined in this report. This methodology covers all new company formations, including start-up ventures not affiliated with a currently rated organization, as well as new company formations within a currently rated group.

A.M. Best’s interactive rating process for insurance companies involves numerous quantitative and qualitative factors that are grouped into three categories: balance sheet strength, operating performance and business profile. A.M. Best’s methodology for rating new company formations uses the same assessments of balance sheet strength and business profile as it does for established companies receiving traditional rating assignments. Similarly, if the new company formation is a member of a rated group, A.M. Best’s methodology Rating Members of Insurance Groups applies as it would for a traditional rating assignment.

New companies are formed for many different purposes, employing a variety of business models. For example, some new companies are an extension or spin-off of an existing operation where the new entity is, in effect, inheriting an existing block of business. In other cases, the new company is a more traditional start-up venture where there is no demonstrated track record of operating performance. A.M. Best’s rating approach for new companies recognizes these distinctions and allows appropriate flexibility in the assessment and evaluation process. Extensive conversations with, and an assessment of, management are central to this process in any new company rating. This assessment of management includes developing an understanding of the organization’s risk management and financial management framework and expertise.

In the case of a true start-up venture, given the additional degree of uncertainty and lack of a track record, assessing the long-term sustainability of earnings and cash flows — keys to the interactive rating process — requires additional rigor in certain areas of the rating process, such as the review and analysis of business plans; the assumptions underlying the company’s projections; and operational controls. In addition, to reflect the heightened level of uncertainty inherent in reviewing a newly formed entity of this nature, more stringent quantitative and qualitative metrics are applied to the rating of a new company formation.

In particular, initial and prospective risk-adjusted capital levels (and related capital metrics, including financial leverage) typically will need to be well above the levels expected of a comparable existing company with a history of ongoing operations that is assigned the same rating. This level of relative conservatism applies throughout the development phase of the new company formation, even after factoring in conservative expectations for earnings and investment returns. This additional capital requirement reflects the new company formation’s lack of operating history and resulting operating risk.

Requirements for Proceeding With the Rating Assignment

For A.M. Best to proceed with an initial rating assignment, certain conditions and factors must be considered:

- A clearly defined five-year business plan that all principals are in accord with and are well qualified and capable to implement. The plan includes:
  - Policy statements on underwriting criteria, investment guidelines and risk management;
  - A thorough description of the products offered, pricing standards and the company’s distribution and market strategy; and
  - Financial projections, along with the underlying quantitative and qualitative assumptions and the anticipated utilization of capital.
• Initial financing in place or expected to be executed with proceeds paid into the capital of the rated (re) insurance entity concurrently with the initial rating assignment.
• Stress-tested capitalization that conservatively supports the assigned rating throughout the business plan.
• Management’s demonstration of a successful track record of operating performance relevant to the new venture’s core business. Experience with organizing new insurance ventures also is factored into the process.
• Experienced management and the appropriate staff and operational infrastructure in place (or adequately addressed in a detailed implementation plan, which may include use of third party servicers) to support initial activities and meet regulatory and rating agency scrutiny.
• Management, board members, strategic investors, investment bankers, actuaries and other advisers available for discussions with A.M. Best and to provide comprehensive disclosure of requested information.
• A follow-up process in place to measure the effectiveness of the initial business plan and to monitor the company’s strategic and financial development.

New Company Rating Process

The objective of any Best's Credit Rating is to provide an opinion of the rated entity's ability to meet its senior financial obligations, which for an operating insurance or reinsurance company are its ongoing insurance obligations. Best’s Credit Ratings include Best’s Financial Strength (FSR), Issuer Credit (ICR) and Debt Ratings. In assigning a credit rating to an established company, A.M. Best looks at balance sheet strength, operating performance and business profile, which is analogous to a review of a new company's initial and prospective capital, sponsorship, business plans, management and operational controls. For definitions of the various types of Best’s Credit Ratings and a comprehensive explanation of Best’s credit rating process, please refer to Best’s Credit Rating Methodology – Global Life & Non-Life Edition on A.M. Best’s website.

The rating analysis of established and new entities is both quantitative and qualitative. Evaluation of key financial ratios is integrated with a qualitative evaluation of the company’s operating plans and philosophies to gain a comprehensive understanding of the company's initial standing and its prospects.

When rating members of groups, A.M. Best employs a top-down and bottom-up approach for both established and new entities within the group. Every legal entity that maintains an A.M. Best rating is reviewed on a stand-alone basis, i.e., the bottom-up analysis. The group's overall strengths and weaknesses also are analyzed, i.e., the top-down analysis. The final published rating for each legal entity within the rated group, including a newly formed subsidiary, considers the potential benefit or drag from its affiliation within a larger organization.

In A.M. Best's credit rating process, all entities, including new company formations, are viewed within the context of the particular country risks to which they are exposed. Under these circumstances, A.M. Best utilizes its country risk methodology, Assessing Country Risk, whereby countries are classified into one of five tiers reflecting the various economic, political and financial system risks that can affect an insurer's financial strength. Country risk is one risk factor among many in the rating process. It affects the rating but does not create a ceiling on the rating of the legal entity or group, and some elements of country risk can be managed in the same manner as other risks are managed. A.M. Best's rating system applies the same rigorous criteria to all insurers, new or established, offering a means of directly comparing insurers regardless of longevity or country of domicile.

Key Rating Factors

The analytical components of A.M. Best’s interactive credit rating process for new insurers involve numerous quantitative and qualitative factors that can be grouped into the two evaluative categories of balance sheet strength and business profile. A third evaluative category of operational controls encompasses the stringent set of qualitative analysis and standards used to assess operating performance, given the lack of a measurable track record of operating performance inherent in a new company formation.

1. Balance Sheet Strength

A. Capitalization

A.M. Best’s assessment of the strength and quality of a company’s balance sheet is the underpinning of any credit rating. Key factors typically reviewed to assess a company's financial stability and flexibility include:

• Initial on-balance-sheet capital level, other committed capitalization and complementary financing sources.
• Stress-tested capitalization, based on the Best’s Capital Adequacy Ratio (BCAR) model under various scenarios, that conservatively supports the assigned rating throughout the operating plan.
• Capital structure – equity and debt financing.
• Use of reinsurance, credit facilities and other forms of contingent capital financing.
• Quality and diversity of assets.
• Regulatory considerations.
• Investor expectations, including earnings and dividends.
• Capital generation anticipated from core business activities.
• Pricing targets.
• Expected reserving levels (conservative or aggressive).
• Investment strategy for reserves and capital. The investment strategy should be consistent with the mix of business, financial plans, liquidity needs and capitalization. Since investment management is important to preserving capital, A.M. Best will review the quality and diversification of assets and the reputation and experience of the investment managers.
• Expertise and processes for managing assets, liabilities and other drivers of enterprise risk individually, as well as the interrelationships among risks. In reviewing initial and prospective capitalization and operating leverage, A.M. Best begins with the capital requirements of the relevant regulatory authorities. This is followed by a rigorous capital analysis using BCAR to assess the capital that is necessary to support the new venture's operations over a period of time and that is appropriate for the types of business written.

**Determining Risk-Adjusted Capital Requirements**

The new company should demonstrate that it can support the execution of its business plan while maintaining risk-adjusted capital adequacy at levels well above what typically would be expected of a more mature company at the assigned rating level throughout the period of the operating plan. The amount of additional capital needed will reflect the risk profile of the business. A higher level of capitalization might be required if the business is subject, for instance, to low-occurrence but high-severity events, or operates in a line of business that typically generates an initial drain on capital due to the slow emergence of profits. A.M. Best also will stress test the pace at which the company expects to utilize its capital. At all rating levels, the capital required will reflect the greater risks inherent in a start-up venture compared with an established company's continuing operations.

As of the initial rating date, A.M. Best expects the new company formation to have adequate on-balance-sheet capital to support appropriate risk-adjusted capital adequacy levels, relative to the rating assigned, considering the company’s projected business activities throughout the five years of the business plan. The BCAR calculated for the new company formation and utilized within the rating process will capture the expected level of business writings, investment and asset risk, general business risk and other elements of risk inherent in the new company’s operations over the five-year period. It is important to note, however, as with any interactive credit rating, that capitalization and the BCAR results are not the sole determining factors in the assignment of a rating. In determining the published initial credit rating, and the corresponding initial on-balance-sheet capital requirement for a specific new company formation, A.M. Best will consider the type of business to be written; expected growth pattern (including whether the plan calls for organic growth or growth through block acquisition); and availability of additional financial support, as well as risks related to the capital structure of the parent or investor providing additional financial support.

A.M. Best’s assessment of the strength and quality of a company’s balance sheet also incorporates an evaluation of the company’s financial stability and flexibility. The level, quality and permanence of capital, including potential distributions of initial investor capital, are evaluated, taking into consideration the company’s appetite for risk, the structure of its assets, its dependence on reinsurance and its liquidity needs. If the organization’s capital structure includes some form of debt, contingent or hybrid capital, additional analysis will be performed in accordance with A.M. Best’s rating methodology - possibly culminating in a public rating on certain debt instruments. For more information, please refer to the following methodologies on A.M. Best’s website: A.M. Best’s Ratings & the Treatment of Debt; Analyzing Contingent Capital Facilities; and Equity Credit for Hybrid Securities. Please note, as mentioned earlier, that to reflect the heightened level of uncertainty inherent in reviewing a newly formed entity, higher quantitative and qualitative standards are applied to the rating of a new company formation.

**B. Sponsorship and Investors**

A new company’s sponsors and/or strategic investors can significantly affect its success in meeting its objectives. Their experience and commitment to the company over the near and long term, including any potential exit strategies, are key considerations in the rating process.

A.M. Best considers the competitive advantages that a sponsor might provide to a new company, as well as the new company’s expected benefits to the sponsor’s core business, as an indication of the sponsor’s likely long-term commitment to the new company. It is also important to understand the return investors expect and the reasonableness of these
expectations relative to the new company’s business plan and existing market conditions. For example, if the sponsor is a rated organization that provides turnkey capability to a new company that, in turn, supports the sponsor’s core business, A.M. Best might view that favorably in the rating process.

If the sponsor also provides financial guarantees or reinsurance support that is acceptable to A.M. Best, this too might enhance the rating assessment. A more conservative rating approach is required of situations where investors are looking to make a quick return because of prevailing, favorable market conditions, as short-term adversity could lead them to withdraw support. In these situations, regulatory controls on paid-up capital, and the likely underlying attractiveness of the operation to future capital providers, are especially important. Expected dividend policy is a key part of the initial rating analysis, and any subsequent increase in the scale or early introduction of dividends compared with the initial plan will be a negative factor in the rating.

The strength of the sponsor/new company relationship is evaluated by considering a variety of factors, such as:

- Type of sponsor or investor – strategic/financial support.
- Level of financial and operational commitment.
- Investors’ return expectations (reasonableness, timeliness, exit strategies) and level of management interaction (active or passive investor).
- Linkage or synergies with an existing insurance or noninsurance organization, such as a mutually beneficial long-term relationship with the sponsor.
- Strategic/operational support (distribution or markets).
- Additional financial support (capital contributions, financial guarantees and reinsurance agreements). For more information on how A.M. Best evaluates potential rating enhancement within an insurance organization, please refer to Rating Members of Insurance Groups at www.ambest.com/methodology.
- Financial flexibility and strength of the sponsor or investor.

2. Business Profile

A. Business Plan and Strategy

A clearly defined business plan is essential. The success of the company depends on management’s ability to effectively implement the business plan while remaining responsive to changing conditions. The business plan and financial targets serve as a benchmark against which A.M. Best will measure the company’s success in the first few years. Some of the areas A.M. Best explores include:

- Targeted lines of business that are consistent with the expertise and track record of management and, if relevant, the company’s strategic investors or its parent company;
- Pricing targets and financial plans that are compatible with expected returns and capital protection and generation; and
- Whether the new company is set up to serve an appropriate business purpose or as a means to reduce taxable obligations.

Key information typically reviewed in A.M. Best’s evaluation includes:

- Well-defined five-year business plan;
- Targeted classes of business;
- Competitive environment and the characteristics that will differentiate the company;
- Distribution/client relationships;
- Pricing methodologies and monitoring practices;
- Return expectations vs. market realities;
- Defined risk management and underwriting policy statements;
- Investment strategies, both long term and short term; and
- Projected financial results, including balance sheet, income statement, cash flows and capital obligations.

B. Management

A.M. Best looks at the depth of the senior management in terms of its track record in critical functional areas, such as underwriting and claims management; financial, investment and risk management; information technology; and marketing, sales and distribution. A.M. Best’s review of management considers:

- Experience in managing other operations through start-up and changing business conditions.
- Financial and operational risk tolerance.
- Consistency of the business plan and investment strategy with those of sponsors or investors and with market realities.
- Alignment of incentive compensation plans, employment contracts and management investments with the attainment of the company’s long-term financial and strategic goals, shareholder value and policyholder security.
- Ability of management to attract key personnel, establish sound business practices, and develop formal monitoring processes and the appropriate infrastructure and operating controls to support operations.
- Succession plans, especially if the founding management is in place only to develop the initial business plan.

3. Operational Controls

Operational controls are important indicators of management’s ability and commitment to the quality and longevity of a new company. These controls should be linked to the monitoring and fulfillment of the business plan. Operational controls also are the means by which the new company’s growth is managed and provide a large measure of risk management. As part of the review of operational controls, A.M. Best considers:

- Whether statements on investment, risk management, underwriting and accounting policy are defined clearly, and whether those statements are consistent with the company’s business plan, capitalization and management’s appetite for risk.
- The company’s valuation methodology for establishing reserves.
- Its monitoring of catastrophic exposures and modeling techniques used.
- Its process for monitoring of pricing and underwriting decisions, including the frequency and depth of the review process.
- Its monitoring and reporting of investment risk exposures (including fluctuations in interest rates, equity markets, inflation and exchange rates) generated by both the company’s asset holdings and its liability structure, as well as the exposure created by the interrelationship of those risks.
- The controls to monitor the new company’s distribution relationships, due diligence, productivity, revenue tracking and expense controls.

A.M. Best’s Monitoring Process

Maintaining a rating on a new company also requires significant ongoing surveillance by A.M. Best, over and above that already required when rating established operations. In assigning an initial rating, A.M. Best and the company agree on a formal plan to monitor the company’s strategic and financial development. This plan usually entails quarterly reviews with management and other principals on the company’s progress toward its stated objectives. Any changes in strategy are discussed and considered in the ongoing rating evaluation.

As with the initial rating, A.M. Best requires detailed disclosure in monitoring the rating. Companies are asked to provide all information necessary for continuing analysis. This generally includes annual and quarterly statements, reviews of risk management, revisions of business plans and documentation on insurance written.
The purpose of this report is to document the existing criteria and methodology related to A.M. Best Co.'s Universal BCAR model, which is used in the evaluation of balance sheet strength for those companies that do not file U.S. or Canadian statutory statements. The Universal BCAR model can also be used in the evaluation of balance sheet strength at the insurance holding company level, regardless of domicile or accounting standard. In addition, the model can also be used to evaluate the prospective balance sheet strength of start-up insurers based on their proposed business plans.

Introduction

The objective of A.M. Best Co.’s financial strength ratings is to provide an opinion of an insurer’s financial strength and ability to meet ongoing obligations to policyholders. The assignment of an interactive rating is derived from an in-depth evaluation of a company’s balance sheet strength, operating performance and business profile as compared with A.M. Best’s quantitative and qualitative standards.

Balance Sheet Strength

In determining a company’s ability to meet its current and ongoing obligations to policyholders, the most important area to evaluate is its balance sheet strength, since it is the foundation for policyholder security. Performance then determines how that balance sheet strength will be enhanced, maintained or eroded over time. Balance sheet strength measures the exposure of a company’s capital to its operating and financial practices. An analysis of a company’s underwriting, financial and asset leverage is very important in assessing its overall balance sheet strength.

Underwriting leverage is generated from current premium writings, reinsurance recoverables and loss reserves. In order to assess whether a company’s underwriting leverage is prudent, a number of factors unique to the company are taken into account, including type of business written, quality and appropriateness of its reinsurance program, and adequacy of loss reserves.

Financial leverage is created through debt or debt-like instruments (including financial reinsurance) and is reviewed in conjunction with a company’s underwriting leverage. An analysis of financial leverage is conducted at both the operating company and holding company levels, since debt at either level could place a call on the insurer’s earnings and strain its cash flow, leading to financial instability.

Asset leverage measures the exposure of a company’s capital to investment, interest rate and credit risks. The volatility and credit quality of the investment portfolio, recoverables and agents balances determine the potential impact of asset leverage on the company’s balance sheet strength.

A company’s underwriting, financial and asset leverage also are subjected to an evaluation by Best’s Capital Adequacy Ratio (BCAR), which allows for an integrated review of these leverage areas. The universal BCAR model calculates the Net Required Capital to support the financial risks of the company associated with the exposure of assets and underwriting to adverse economic and market conditions, and compares this required capital to economic capital. Some of the stress tests within BCAR include above-normal catastrophes, a decline in equity markets and a rise in interest rates. This integrated stress evaluation permits a more discerning view of a company’s balance sheet strength relative to its operating risks.

A company’s BCAR result is extremely useful in evaluating its balance sheet strength, but BCAR is only one component of that analysis. In addition, balance sheet strength is only one component of the overall financial strength rating, which also includes operating performance and business profile. BCAR establishes a guideline for risk-adjusted capital to support a rating, but other factors driving expectations of future balance sheet strength drive the rating as well. All of these factors are important to the overall rating process.
Overview of BCAR

A.M. Best’s capital formula uses a risk-based capital approach whereby net required capital is calculated to support three broad risk categories: investment risk, credit risk and underwriting risk. A.M. Best’s capital adequacy formula also contains an adjustment for covariance, reflecting the assumed statistical independence of the individual components. A company’s adjusted capital is divided by its net required capital, after the covariance adjustment, to determine its BCAR.

Investment Risk

Investment risk includes three main risk components: fixed-income securities, equities and interest rate. Capital charges are applied to different asset classes based on the risk of default, illiquidity and market-value declines in both equity and fixed-income securities. Additionally, higher capital charges are ascribed to affiliated investment holdings, real estate, below-investment-grade bonds and nonaffiliated, privately traded common and preferred shares because of the illiquid nature of the asset and/or the potential volatility of the reported value.

The levels of liquidity and volatility in a country’s capital markets are an important part of A.M. Best’s analysis. The influence of market liquidity and volatility on the financial system and the broad macro economy are captured in A.M. Best’s Country Risk Methodology. These risks include, but are not limited to, sharper and more frequent business cycles caused by more volatile consumption and investment, and increased uncertainty concerning access to capital. The greater the degree of market volatility, the more difficult the operating environment for insurers.

These country-specific risk factors also can have a direct impact on an insurer’s risk-adjusted capital. At the company level, illiquidity and volatility will depress an asset’s valuation, and in extreme scenarios, severely limit access to cash. The potential for market illiquidity and volatility to increase the risk within an insurance company’s invested assets or diminish financial flexibility is captured through country-specific risk charges, based on the origin of the asset, within A.M. Best’s Universal BCAR model.

In some instances, some or all of the risk associated with a particular asset may be borne by the policyholder. In those situations, the investment risk to the insurance company may be reduced.

A.M. Best’s capital model incorporates an interest-rate risk component that considers the decline in market value of a company’s fixed-income portfolio as a result of rising interest rates. The interest rate risk calculation will reflect the fact that companies writing life and annuity products will have an exposure to disintermediation and cash-flow mismatch risks, whereas a company writing property/casualty products will have an interest-rate risk exposure when a shock event occurs. Interest rate risk for annuity writers will vary based on the type of products offered and the source of that business.

Investment risks are typically the main drivers of a life and annuity insurer’s capital requirements.

Credit Risk

Capital charges are applied to different receivable balances to reflect third-party default risk. Credit risk factors are ascribed to recoverables from all reinsurers, including affiliates. Required capital for credit risk may be modified after taking into account acceptable collateral offsets for reinsurance balances; the quality of the reinsurers that participate in the company’s reinsurance program; and the company’s dependence on its reinsurance program. Also included in the credit risk component are charges for premium balances receivable; accrued retrospective premiums; deposits in pools and associations; funds held by ceding insurers; and other, miscellaneous receivables.

Underwriting Risk

This category encompasses the risks associated with net loss and loss-adjustment expense reserves, net premiums written and net unearned premiums. The reserve component requires capital based on the risk inherent in a company’s loss and loss-adjustment expense reserves, adjusted for A.M. Best’s assessment of its reserve equity. Reserve equity is a function of the estimated reserve deficiency, the payout pattern of the reserves and the discount rate, which is currently 4% in BCAR. The net premiums written component is a forward-looking component and requires capital based on the pricing risk inherent in a company’s expected book of business for the upcoming year. The unearned premium component reflects the exposure to pricing risk on premium that was written in the past but is still unearned as of the current evaluation date and can be a material exposure for long duration contracts.

Long duration property/casualty contracts are defined as contracts having terms in force for more than 13 months and for which the insurer cannot cancel or increase the premium during the life of the contract. Long duration unearned premiums will be included on the loss reserve page and other adjustments will be made in an effort to capture other risks associated
with writing long duration contracts. In the case of a contractual liability policy (CLIP), where the insurer guarantees the liabilities of another entity for a fee, the underlying unearned premium that is being guaranteed will be added to the loss reserve page instead of the unearned CLIP premium.

Required capital for the underwriting risk components may be increased to reflect an additional surcharge for “excessive” exposure growth. In addition, there is credit for a well-diversified book of business, but this credit is minimized for those companies that maintain small books of many lines of business and may not necessarily have expertise in each of them. For those composite companies that write both property/casualty and life insurance, the amount of diversification credit may be increased to reflect the additional benefits from diversifying across insurance sectors.

For life and health insurers, underwriting risks are divided into mortality risks, longevity risks and morbidity risks. Mortality risks are based on volume of life insurance in force, net of reserves and reinsurance, with risk charges grading lower for higher amounts at risk. Longevity risks are present in annuities and certain types of pension plans, as plan participants are living longer than expected when payment amounts originally were determined. Morbidity risks vary by line of business and therefore warrant different charges. Generally, health care lines of business with long-tail risks (disability, long-term care) will have higher premium risk charges than shorter tail risks (medical, critical illness).

For property/casualty insurers, underwriting risk is typically the largest risk category and usually accounts for two-thirds of a company’s gross required capital.

**Required Capital**

Collectively, the investment, credit and underwriting risk components generate more than 99% of a company’s gross required capital, with the business risk component generating minimal capital requirements for off-balance-sheet items. Off-balance-sheet items include items such as noncontrolled assets, guarantees for affiliates, contingent liabilities, pension obligations and other post-employment/retirement obligations. A company’s gross required capital, which is the sum of the capital required to support all of its risk components, reflects the amount of capital needed to support all of those risks if they were to develop simultaneously. However, these individual components then are subjected to a covariance calculation within the BCAR formula to account for the assumed statistical independence of these components. This covariance adjustment essentially says that it is unlikely that all of the individual risk components will develop simultaneously, and this adjustment generally reduces a company’s overall required capital.

A.M. Best recognizes the distortions caused by the “square root rule” covariance adjustment, whereby the more capital-intensive risk components are disproportionately accentuated while the less capital-intensive risk components are diminished in their relative contribution to net required capital. Nevertheless, by using other distinct capital measures, A.M. Best can counterbalance this apparent shortcoming.

**Determination of Available Capital**

A.M. Best makes a number of adjustments to a company’s reported capital within its universal capital model to provide a more economic and comparable basis for evaluating capital adequacy. Different accounting methods and regulatory requirements across the world require numerous adjustments to a company’s reported capital. Goodwill and other intangible assets are eliminated. Pre-event catastrophe reserves are removed from the loss reserves and moved into available capital on a tax-effected basis. Adjustments for any embedded value in unearned premium reserves, loss reserves and fixed-income securities are made if the company has not already reflected these in its reported capital. Further adjustments are made to capital to reflect other non-balance sheet risks, including catastrophe exposures and debt-service requirements.

A.M. Best’s capital model emphasizes permanent capital and consequently will reduce a company’s reported surplus for encumbered capital, which includes surplus notes and future debt-service requirements of an affiliated holding company. This reduction, in whole or in part, depends on the magnitude of, and dependence an insurance group has on, debt-like instruments and their associated repayment features.

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<th>Exhibit 1</th>
<th>Available Capital Components:</th>
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<td>Value in Force (Life Business)</td>
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On a qualitative basis, issues such as where the debt is held vs. where the cash is used; the existence of other sources of income to offset the cost of debt; fixed-charge coverage; and the overall level of debt relative to the organization's total capital all are considered. For example, when debt is issued at the holding company but the cash is held at the operating insurance company, even though the cash is given full credit in the BCAR analysis of the operating company, the actual rating of the operating company could be limited by the evaluation of the financial leverage and earnings coverage at the holding company.

**Formula Drivers**

A company’s gross capital requirement within A.M. Best’s capital model is generated primarily from its investment, credit and underwriting risks. A company that maintains a more aggressive investment portfolio, is heavily concentrated in one asset or sector, or is heavily dependent on pyramided capital likely will generate a lower BCAR value. Companies that have excessive exposure to third-party credit risk or are heavily dependent on reinsurance likely will generate lower BCAR scores. The amount of required capital generated from the underwriting risk components is largely a function of the company’s mix of business, amount of available capital, growth in exposure, stability of loss development, profitability, loss-reserve adequacy and length of claims payout. All other things being equal, the absolute BCAR score of a company will be lower because of higher capital requirements associated with greater indicated reserve deficiencies, as well as unstable or unprofitable business.

In addition, the model can be adjusted in response to various market issues. Some examples of the issues that can impact capitalization include rate changes, the stage of the underwriting cycle, changing reinsurance products and reinsurance dependence. The ability of the model to respond to these market issues makes it a robust tool that assists in the evaluation of the company’s balance sheet strength.

The basis of risk measurement for some of the key drivers of required capital in the universal BCAR model is expected policyholder deficit A.M. Best adopted the concept of expected policyholder deficit to better calibrate the model’s loss-reserve and premium-risk factors, as well as other risk factors in the model. The concept of expected policyholder deficit allows risk charges to be calibrated to a specific level of insolvency risk and also takes into consideration the expected cost, or severity, of insolvency.

**BCAR Is an Absolute Measure**

The universal BCAR model produces an absolute score, which is the ratio of the company’s adjusted capital to its own net required capital. This company-specific capital ratio indicates whether its capital strength aligns with A.M. Best’s “Secure” or “Vulnerable” rating categories and is based on the specific risk profile of a company’s operations. A BCAR score below 100% would be considered vulnerable. Given strong, stable operating performance, sound risk management, high quality capital and strong financial flexibility, Exhibit 2 provides a reasonable guide for the BCAR levels needed to support A.M. Best’s Financial Strength Ratings.

**Additional Stress Testing**

A.M. Best also will stress a company’s BCAR score for a second catastrophic event according to the procedures outlined in its criteria report titled *Catastrophe Analysis* in A.M. Best Ratings and its criteria report titled *The Treatment of Terrorism Risk* in the Rating Evaluation. The testing will incorporate natural catastrophes and/or man-made events such as terrorism to monitor how sensitive a company’s balance sheet strength is to a second catastrophic event. For casualty writers, an estimate of a casualty shock loss may be used in the analysis of balance sheet strength. Additional stresses may be employed when insurers accumulate large amounts of higher risk investments.

**Conclusion**

The tools to allocate capital and understand capital strength continue to evolve. These tools often vary in theory, purpose and outcome. It is important to remember that, while they can add significant value, they are only tools. A.M. Best’s proprietary universal BCAR is one of those tools that look at capital needs well above financial solvency. A.M. Best will continue to enhance BCAR going forward to improve its accuracy in measuring balance sheet and operating risk.

BCAR is important to A.M. Best’s evaluation of both absolute and relative capital strength. Consistent with standards embedded within the universal BCAR model, A.M. Best would expect that well-managed and highly rated companies will maintain capitalization levels in excess of the risk-adjusted amounts indicated by the published guidelines to support their current ratings.
A.M. Best is quick to caution, however, that although BCAR is an important tool in the rating process, it isn’t sufficient to serve as the sole basis of a rating assignment. BCAR, like other quantitative measures, has some limitations and doesn’t necessarily work for all companies. Consequently, capital adequacy should be viewed within the overall context of the operating and strategic issues surrounding a company. Business profile and operating performance are important rating considerations in evaluating a company’s long-term financial strength and viability as well as the quality of the capital that supports the BCAR result. In addition, any holding company considerations also will play a key role in evaluating the financial strength of an insurance company.

In closing, A.M. Best believes that well-managed and highly rated insurers will continue to focus on the fundamentals of building future economic value and financial stability, rather than on managing one, albeit important, component of A.M. Best’s rating evaluation.
The World of Captive Ratings — What type of captive seeks a rating?

A.M. Best currently rates over 200 captive ventures, representing a wide range of risk financing structures. We have focused on this niche sector of the insurance industry for about 30 years, continually expanding our coverage in response to growing interest in ratings by captive practitioners. This report looks at this portfolio of ratings to discern common features and to understand better the reasons why captives might seek a rating.

The questions we will answer are:

- How large must a captive be for it to be eligible to be rated?
- Will the rating merely reflect the status of the parent?
- How mature must the captive be to be suitable to be rated?
- Is the industry sector of the parent or the group the captive serves important?
- Do particular lines of business make a captive more suitable to being rated?
- Is domicile a relevant factor?
- Will the rating be determined by the quality of the captive’s reinsurance?
- Does how the captive is managed make a difference?

Although 200 is a substantive sample from which worthwhile conclusions can be drawn, it does nevertheless represent a small fraction of the worldwide captive sector, which in 2013 totalled 6,342 [Marsh 2014 Captive Benchmarking Report]. While we expect the number of rated captives to continue to grow it is unlikely to reach a substantial portion of the global captive population. This is because there will be insufficient stakeholder pressure on most captives to contemplate a rating, or their operations will be too modest to warrant such an initiative. Nevertheless, corporate governance considerations and regulatory developments will, we anticipate, make this a more common captive management agenda item.

In terms of market share, A.M. Best is the leading credit rating agency for captives (as it is in other sectors of the insurance market), with the great majority of rated captives carrying a Best’s Financial Strength Rating. A few have a second rating. The reasons a captive might want a rating are various but typically relate to its interface with the conventional market, both through fronting and reinsurance, and the requirements of regulators and business partners.

Market Comparison

As captives have a preferential relationship with their insureds, understanding the risks better and typically not having to compete aggressively for business as if in the open market, it may be anticipated that the performance of rated captives will reflect this. Captives can be more selective and better informed in their underwriting, and groups that establish captives may be expected to have above average risk management systems. On the other hand, captives can seldom achieve the level of diversification that most conventional insurers do, a diverse mix of business

Is there a special rating scale for captives?

No. All Best’s Financial Strength Ratings are presented on the same scale, and the analysis on which our opinion is based will be consistent whatever the type of insurer or wherever it is located. But we do recognize that captives are different from conventional insurers, for example in their objectives and their methods of operation, and this is taken into account in their appraisal.
The profile of Best's captive ratings, which are expressed on a global industry wide scale, is shown in Exhibits 1a and b. As with other types of insurers, captives are assigned both a Financial Strength Rating (FSR) on Best's traditional insurance market scale and an Issuer Credit Rating (ICR) on the capital markets scale. The alignment of the two scales is shown in Exhibit 1c.

80% of Best's ratings of captives fall within the A range (designated “Superior” or “Excellent”). Over 95% are categorized as Secure. This distribution is broadly in line with the overall insurance industry, where A.M. Best rates approximately 3,400 companies in over 80 countries. However, in the case of rated single parent captives (37% of the total portfolio), 93% have ratings in the A range (see Exhibit 2). This superiority is a measure of the success of these ventures as risk management tools, reducing the total cost of risk of the groups they serve and resulting in high levels of captive capitalization (as measured by Best’s Capital Adequacy Ratio (BCAR)).

Looking back to the time when these ratings were first assigned (63% in the A range), it may be concluded that, as a group, the financial strength of these captives has improved; on average these ratings have been in issue for 11 years and 42% are now rated higher than originally. 10% are at a lower level than when first rated and, also, over the years some ratings have been withdrawn for various reasons. Generally, rating changes are infrequent, with these captives demonstrating their resilience and ensuing risk mitigation in the event of adverse loss experience.

Each year, A.M. Best issues a report on those captives based in the USA that it rates, making comparisons with a composite of conventional insurers. Under many headings, rated captives can be seen to be outperforming their conventional peers (see Exhibit 3).

By these criteria, captives achieve better than average underwriting results and are operated more efficiently than the market from which they are capturing premium, and have done so consistently. The contrast is more apparent in the case of single parent captives where the Combined and Operating 5 year average ratios are 64% and 52.5% respectively, reflecting the enterprise risk management role performed by captives and what typically is a lower cost-base than for much of the industry.

Conclusion:
Although captives can rarely compare with most insurers in terms of both business mix and resources, and may serve wider risk management purposes, this need not undermine their rating prospects.
Size

Ratings penetration of insurance markets tends to increase as insurance companies get bigger. This is true both generally and in the captive sector. Larger entities are more likely to have a scope and scale of operations to which a rating can bring benefit. However, that does not mean that size is the overriding factor in determining rating outcome. So, while a very large captive such as BP’s Jupiter in Guernsey (with capital and surplus measured in USD billions) carries a rating of A, a more modest captive such as Micronesia based Marble (the captive of the Marubeni Corporation of Japan) can still achieve a rating of A– with a capital base of less than USD 20 million. This is because Best’s rating methodology takes into account a wide range of features under the general headings of financial strength, operating performance, business profile and enterprise risk management. No single aspect will determine the rating outcome.

Exhibit 4a

Rated Captives by Size (Capital & Surplus)

Exhibit 4b

Rated Captives by Size (Net Written Premium)

Sources: Best’s Statement File – Global, A.M. Best research.

Nearly one-third of rated captives have a capital and surplus of less than USD 25 million, with the lowest value being less than USD 1 million. Importantly, in the rating process the assessment of capital adequacy is risk based and not some arbitrary minimum requirement. Judged in terms of size by net worth and by premium income, captives rated by A.M. Best are summarized in Exhibits 4a and b.

Conclusion:

Although capitalization is the first consideration, much of the quantitative analysis on which ratings are based concerns financial ratios where size is not the main element. Size can provide greater financial flexibility (a positive rating factor) but it is not a dominant feature of rated captives.

Reflected Glory?

Of course, it may be argued that groups such as BP are major corporations and therefore the ratings on their captives simply mirror that. In fact, like all entities rated by A.M. Best, a captive will in the first instance be rated on a stand-alone basis and only then will group context be added. Clearly, a captive’s rationale derives from the group it serves and the risk management program it is a
part of, so group context is fundamental. Certainly, many rated captives are part of large successful groups, the support of which will reinforce the captive’s status.

### Conclusion:

When it rates a captive, A.M. Best expresses an opinion on the performance and prospects of the captive, not its parent or sponsors. Group context is important but unless the rating relates specifically to the captive, its usefulness to other parties may be doubted.

However, this does not mean that a captive’s rating is tied to that of its parent; a parental rating may move for reasons that have no bearing on the performance of the captive. As A.M. Best only rates insurance entities it will not be rating the parent (unless an insurance group) and therefore its opinions need not be constrained by such ratings. So, under A.M. Best’s methodology whereby a captive is judged on its own merits, it is possible for a captive to achieve a higher rating than its parent (as issued by another rating agency). Although this would be unusual in practice, it is not unknown (see Exhibit 5).

Also, although A.M. Best only rates (re)insurance companies, a captive can be rated by A.M. Best without its parent having been rated by another agency.

### Maturity

Lufthansa’s captive, Delvag (rated by A.M. Best since 2007), was formed in 1924 but such longevity is exceptional for a captive, whether rated or not. The age at which a captive is first rated does not seem to be a major factor, ranging as it has from a captive’s inception to over 80 years. Half these captives were assigned a rating when less than 10 years old. (see Exhibit 6). This suggests it is business need rather than maturity that will prompt a captive to be rated. Of course, however old the captive, its participation in group insurance arrangements will typically be based on many years’ experience of a risk profile that is well understood and well recorded. Hence, although many captives are not that mature when a rating is first assigned, the analysis on which that rating is founded can look back over a longer period.

### Conclusion:

Whatever the stage of development of a captive, the benefits of being rated can be achieved.

---

**Exhibit 6**

**Age of Captive at First Rating**

<table>
<thead>
<tr>
<th>Stage</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 5 years</td>
<td>23%</td>
</tr>
<tr>
<td>5 - 10 years</td>
<td>32%</td>
</tr>
<tr>
<td>10 - 20 years</td>
<td>29%</td>
</tr>
<tr>
<td>Over 20 years</td>
<td>16%</td>
</tr>
</tbody>
</table>

Sources: Best’s Statement File – Global, A.M. Best research.
Ownership, Scope of Coverage and Industry Sector

If business need is the main driver for a captive to be rated, a supplementary question is whether captives underwriting certain lines of business or those operating in a particular industry sector may be more likely to see value in being rated.

The major US focus of the rated captive population (see Geographical Orientation below) is significant in this regard in that US captive usage is skewed towards liability covers, as compared with other parts of the world in which property is often the main class of captive underwriting. Cover for liability exposures, which are inherently more uncertain in quantum and where claims can take many years to settle, poses greater questions about insurer security. Hence the need for a captive to be rated.

Captives supporting groups that operate through joint ventures or which cover third-party risks (including those related to employees and customers) might be expected to face greater external interest in their financial strength or creditworthiness, which a rating can serve to address. In some cases there are commercial requirements to use rated paper. In fact, A.M. Best’s experience suggests that such a more expansive use of a captive is not in most cases the major factor in the decision to seek a rating.

On the other hand, captives that have multiple ownership or sponsorship are more inclined to be rated. Risk Retention Groups and Group Captives make up 55% of the rated population (see Exhibit 7) whereas, according to the 2013 Captive Insurance Directory published by Captive Review, these categories represent only 16% of all captives and in the Marsh survey (possibly less representative as it is based on Marsh managed captives only (less than 20% of the global total)) their share is just 7%. Where the ownership of a captive is more dispersed, participants are more likely to seek a rating (being as it is an informed and independent opinion of the captive’s status) as a means of protecting their interests. In the case of Risk Retention Groups (a particular US structure with membership based on common liability exposures) 17% are now rated by A.M. Best. Here, both sponsorship and the long-tail nature of the business underwritten contribute to the demand for ratings.

In the case of rated single parent captives, an interesting distinction can be made between those located in the US and elsewhere. For US-based rated captives, only 25% are single parent captives, whereas in all other domiciles the proportion is 68%. Again, this reflects how captive structures have developed differently around the world.

The industry sector distribution of rated captives (see Exhibit 8) shows that healthcare and oil & gas/energy are the main sources. That healthcare is the largest individual sector from which rated captives are drawn (23%) is partly a measure of its role in the US economy and the fact that most captives worldwide are of US ownership. The US healthcare industry has traditionally faced conventional insurance challenges which captives have been used to overcome. 38% of the net premium of the US rated captives composite referred to related to medical professional liability in 2013 (52% in 2012). These arrangements need to be acceptable to various stakeholders, which a rating may help achieve.

Major energy companies are characterized by their size and geographical reach, are subject to regulation and often operate through joint ventures, all of which point to the need for ratings. These companies, with stronger balance sheets than most insurers, prefer to self-insure their risks, making active use of their captives.
Focusing on single parent captives, oil & gas/energy is the leading sector (28% of rated captives) followed by financial institutions (10%) for which credit sensitivity is a major consideration.

A more recent trend is for insurance groups to establish captives to optimize retention capacity and coordinate the purchase of reinsurance protection. Increasingly, these facilities are being rated to achieve regulatory recognition. There is a certain irony in insurers utilizing a risk financing facility originally developed to compete with the conventional market.

**Conclusion:**
Rated captives are active in diverse industry sectors, with some showing a greater propensity to seek ratings, but it will be the underlying risk management purpose of the captive that will determine whether it does so.

**Geographical Orientation**
Although the origins of the insurance industry in Europe had a discernible captive dimension, in its modern formulation captive usage has been and remains a predominantly US phenomenon. Indeed, in recent years the US share of the global captive population, both by ownership or location, has increased (to 58% according to the Marsh survey). Given also that ratings coverage of the US insurance market in general is more extensive than in any other part of the world, a contrast that dates back decades, it is not surprising that over 80% of rated captives have a North American connection (see Exhibits 9a and b).

The continued formation of US captives, at a faster rate than in any other region (increasingly domiciled onshore as most States have now passed legislation promoting such ventures), suggests this picture will not change much in the near term. Nevertheless, in the past three years, A.M. Best has issued new ratings on captives domiciled in such widespread locations as Ireland, Luxembourg, Malta, Russia, Malaysia (Labuan), Micronesia and New Zealand.

Various commentators have expressed the expectation that greater captive usage will develop in Europe and Asia in line with economic growth and evolving insurance market practice. This in turn should lead to more captives in those regions being rated, which Solvency II and other regulatory initiatives can also be seen to be encouraging.

As previously mentioned, rated single parent captives have a lesser US orientation. As this captive type is the most widespread globally (56% or 66% according to Captive Insurance Directory and Marsh survey respectively) it likewise points to further expansion of rating coverage in other regions.

**Conclusion:**
The benefits of a captive rating will generally not be determined by the location of the captive.

**Reinsurance**
As one of the textbook rationales for forming a captive is to gain access to the reinsurance market, are ratings on captives going to be derived from the quality of their reinsurance? This is certainly a rating factor but in practice the retention ratio of these captives (the proportion of gross premium they hold on to) is relatively high. In A.M. Best’s US study, the
ceded leverage ratio for captives (0.3 to 1) demonstrates a lower dependence upon the security provided by reinsurers than the commercial composite (0.8 to 1).

Most rated captives may be seen primarily as risk financing facilities rather than a mechanism for risk transfer, often with the higher value exposures of the parent being placed directly into the (re)insurance market, access to which in the modern era does not require captive participation. Rated captives are likely to adopt a more explicit risk-taking stance in pursuit of a reduction in the total cost of risk, rather than depending on reinsurance to obtain what effectively is a saving in acquisition costs in securing cover.

The quality of a captive’s reinsurers will be reflected in the assessment of its capital adequacy. Reinsurance entails credit risk which impacts risk-based capitalization requirements, with the rating of reinsurers being expressed in the capital charges that apply. But even where there is, unusually for rated captives, a dependence on reinsurance, this will be just one of several factors determining the rating outcome.

**Conclusion:**
Rated captives will typically maximize retained premium and look to reinsurance protection for more extreme exposures.

**Management**
Using a rating as a proxy quality mark for captive performance may also be seen in the management structures adopted by rated captives. The normal arrangement for the sector in general is for a captive to outsource management services to a specialist firm, whether part of a broker-owned network or an independent. It is relatively unusual for these functions to be handled in-house. However, this is much less true in the case of captives rated by A.M. Best (see Exhibit 10).

It may be surmised that self-managed captives can face greater scrutiny of their arrangements than where specialist service providers with an established market reputation are retained, and therefore a rating might be used by a risk manager to demonstrate that a captive operated in this manner is achieving international best practice. Also, a self-managed captive could be better placed to play a more integral and strategic part in its group risk management infrastructure, which a rating might support.

**Conclusion:**
Rated captives tend to have a more active operational style.

**The Demand for Captive Ratings**
This report has shown that A.M. Best currently rates a wide range of captives. A.M. Best’s recent experience suggests that this range will continue to expand, particularly in terms of geographical spread. Distilling the record of rated captives so far, the following conclusions can be drawn about the type of captive that could benefit from being rated. Such a captive is likely to be seen as a positive risk management tool, interacting confidently both with the operations of its wider group and the insurance market, demonstrating to stakeholders that it has clear objectives and is appropriately resourced to pursue them.

As noted, only a minority of captives is likely to seek a rating. However, the range of currently rated captives suggests there are many comparable captives that might also benefit from being rated. Indeed, a survey undertaken by Captive Review and published in its February 2014 edition indicated that 60% of the captives surveyed which were not already rated were considering being rated in the next five years, with 40% likely to seek a rating. This may have been an unusual sample (for example 29% were currently rated, as compared with a global average of about 3%), but the results point to ratings moving towards the mainstream of captive practice. A major element of the interest in being rated expressed in this survey was related to fronting and collateral requirements, which might be eased with an appropriate rating. Certainly, there are cases where a rating has helped a captive gain improvements in this area, and recently a leading provider of fronting facilities has started to encourage cedant captives to be rated.

General trends in the international insurance market include the more widespread requirement that rated security be used and it may be anticipated that this will also be evident in the captive sector. Regulatory pressures in many countries will also have the same effect. In addition, corporate governance considerations are having greater significance in the
oversight of captive usage. Boards of groups with captives that have no other insurance operations are sensitive to the responsibility to understand such ventures and be assured that they are under control. Likewise, as groups disclose more in their statutory reporting about the risks they face and how these are being managed, reference to the use of a captive may raise further questions from external interested parties. In both respects by being rated a captive can be better placed to withstand such scrutiny.

Conclusion:

As captives become more complex and operate in an environment demanding greater transparency and accountability, A.M. Best expects to expand its rating coverage of the sector. Similarly, as captive usage becomes decoupled from general market cycles and is less opportunistic, an observed trend, demonstrating the value of a captive will become more important. Consequently, captive practitioners and wider stakeholders will need to become more familiar with the process by which ratings are assigned, the insight that they provide and the use to which they can be put.

Circumstances in which captives and their owners have benefited from a rating include:

• A demand for increased accountability and transparency (e.g. as driven by corporate governance and capital efficiency considerations).

• Questions are raised about the captive’s rationale following some major change (e.g. a merger or new Chief Financial Officer).

• Third-party business is planned.

• Joint ventures involve risks suitable for the captive.

• Fronting is required but it is inefficient.

• Reinsurance availability is problematic.

• Leasing and other financial constraints restrict captive participation.

• Heightened regulatory oversight.
U.S. captive insurers rated by A.M. Best continue to outperform the commercial sector in every key financial measure. Of note in 2013 was a 12.4-point improvement in the loss and loss-adjustment expense ratio over the prior year, mainly due to the lack of any major, outsized property losses. The 2012 results were driven largely by Superstorm Sandy.

Underwriting expenses improved to a five-year low in 2013. Captives’ expenses are normally lower than conventional insurance markets, mainly because they have lower overhead and associated expenses, and most if not all of them do not rely heavily on items such as agents’ commissions (see Exhibit 1).

Over the longer term, the five-year average combined ratio for the captive composite of 85.2 continues to compare extremely favorably with the commercial composite’s average of 103.2 (see Exhibit 2). The captives’ operating ratio over the same five-year period is tighter, with the captives generating a five-year operating ratio of 69.7 versus 88.3 for the commercial composite. It is well known, given that the majority of single-parent captives use loan-back instruments with their parents, that captives’ investment portfolios tend to be significantly more conservative, and therefore generate less income, than typical investment portfolios for commercial companies.

The captive companies analyzed by A.M. Best for this report were taken from a subset of more than 200 captive companies, all of which currently are rated. Those companies range in size from $2 million in surplus to more than $3.5 billion. These captive companies write (in size order) medical malpractice, inland marine, general and automobile liability, property, workers’ compensation and other lines. A.M. Best has used the commercial casualty composite for comparative purposes throughout the report.

It should be noted that captive companies form in order to satisfy a market shortfall for an underserved class of business. As these captives mature, they often expand into quasi-related and/or unrelated classes of business. In early 2014, A.M. Best reviewed the rated group captives that have altered their focus and eliminated them from the composite. While this has changed some totals from prior years, it has had very limited impact on the ratios recorded by the group and the assertions that were made in previous versions of this annual report.

Operating Performance
Captives’ surplus grew by $1.51 billion, or 7.8%, with a $589 million, or 50%, increase in net income in 2013 (see Exhibit 3). The increase was mainly due to improved underwriting and lower losses and LAE. In 2013, net income was $1.76 billion, which was supplemented by $471 million of unrealized capital gains and a reduction of $224.8 million by other surplus events. These additions to surplus were offset in part by dividends to owners of $509 million. Generally, captives are not intended to be profit-making vehicles, but captive owners often take dividends to “right size” the capital.

The increase in net income was the result of a $670 million, or 124%, increase in net underwriting income, coupled with increases in net investment income and realized capital gains of $20.9 million and $39.5 million, respectively. These items were offset in part by a $152.9 million, or 39%, increase in income taxes (see Exhibit 4).

The increase in underwriting income of $670 million was due to a $426 million, or 11.7%, decrease in incurred loss and LAE coupled with a $14 million decrease in underwriting expenses, as well as an increase in net earned premium of $384 million, or 7.3%. These items were offset in part by an increase in policyholder dividends of $155 million, or 66.4%.

While not as severe as in 2012, property losses – some still related to Sandy – hit some of the single-parent and group captives in 2013. Regardless, the loss and LAE ratios for 2013 were the lowest of the past five years. The very concept of a
### Exhibit 1

**U.S. Captive Insurance – Underwriting/Operating Ratios**  
(%)  

<table>
<thead>
<tr>
<th>Year</th>
<th>Pure Loss</th>
<th>Loss-Adjustment Expense</th>
<th>Loss &amp; LAE</th>
<th>Commission Expense</th>
<th>Other Expense</th>
<th>Total U/W Expense</th>
<th>Combined Ratio Before Policyholder Dividends</th>
<th>Policyholder Dividends</th>
<th>Combined Ratio A/PHDS</th>
<th>Net Investment Ratio</th>
<th>Operating Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>51.1</td>
<td>18.9</td>
<td>70.0</td>
<td>1.7</td>
<td>13.7</td>
<td>15.3</td>
<td>85.3</td>
<td>4.2</td>
<td>89.5</td>
<td>17.6</td>
<td>71.9</td>
</tr>
<tr>
<td>2010</td>
<td>47.6</td>
<td>16.2</td>
<td>63.8</td>
<td>1.6</td>
<td>13.6</td>
<td>15.2</td>
<td>79.0</td>
<td>8.2</td>
<td>87.2</td>
<td>16.4</td>
<td>70.8</td>
</tr>
<tr>
<td>2011</td>
<td>45.0</td>
<td>17.3</td>
<td>62.3</td>
<td>1.5</td>
<td>13.7</td>
<td>15.2</td>
<td>77.5</td>
<td>5.0</td>
<td>82.5</td>
<td>15.4</td>
<td>67.1</td>
</tr>
<tr>
<td>2012</td>
<td>52.6</td>
<td>17.0</td>
<td>69.6</td>
<td>2.0</td>
<td>13.5</td>
<td>15.5</td>
<td>85.1</td>
<td>4.5</td>
<td>89.6</td>
<td>14.6</td>
<td>75.0</td>
</tr>
<tr>
<td>2013</td>
<td>42.4</td>
<td>14.9</td>
<td>57.2</td>
<td>1.9</td>
<td>12.1</td>
<td>14.1</td>
<td>71.3</td>
<td>6.9</td>
<td>78.2</td>
<td>14.0</td>
<td>64.3</td>
</tr>
</tbody>
</table>

5-Yr. Avg.  
- Captive: 47.6  
- Industry: 58.5  

Source: A.M. Best data & research

### Exhibit 2

**U.S. Captive Insurance – Profitability Analysis**  
(%)  

<table>
<thead>
<tr>
<th>Year</th>
<th>Return on Invested Assets</th>
<th>Return on Revenue</th>
<th>Return on Equity</th>
<th>Underwriting &amp; Operating Ratios</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Investment Yield</td>
<td>Net Inv Inc (W/Realized Capital Gains)</td>
<td>Total ROIA</td>
<td>Pretax Oper Inc/ NPE</td>
</tr>
<tr>
<td>2009</td>
<td>3.4</td>
<td>3.5</td>
<td>6.3</td>
<td>28.9</td>
</tr>
<tr>
<td>2010</td>
<td>2.9</td>
<td>4.1</td>
<td>5.3</td>
<td>29.7</td>
</tr>
<tr>
<td>2011</td>
<td>2.7</td>
<td>3.2</td>
<td>2.9</td>
<td>33.4</td>
</tr>
<tr>
<td>2012</td>
<td>2.5</td>
<td>3.3</td>
<td>4.6</td>
<td>25.2</td>
</tr>
<tr>
<td>2013</td>
<td>2.4</td>
<td>3.3</td>
<td>4.8</td>
<td>35.9</td>
</tr>
</tbody>
</table>

5-Yr. Avg.  
- Captive: 2.7  
- Industry: 4.3  

10-Yr. Avg.  
- Captive: 3.2  
- Industry: 4.6  

Source: A.M. Best data & research

### Exhibit 3

**U.S. Captive Insurance – Financial Indicators**  
(USD Thousands)  

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Premiums Written</th>
<th>% Chg</th>
<th>Pretax Operating Income/ Loss</th>
<th>% Chg</th>
<th>Net Income/Loss</th>
<th>% Chg</th>
<th>Admitted Assets</th>
<th>% Chg</th>
<th>Loss &amp; LAE Reserves</th>
<th>% Chg</th>
<th>Year-End Surplus</th>
<th>% Chg</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>4,488,013</td>
<td>14.1</td>
<td>1,297,329</td>
<td>20.8</td>
<td>976,775</td>
<td>421.1</td>
<td>28,516,066</td>
<td>13.0</td>
<td>9,283,949</td>
<td>5.2</td>
<td>14,198,756</td>
<td>21.2</td>
</tr>
<tr>
<td>2010</td>
<td>4,663,960</td>
<td>3.9</td>
<td>1,394,945</td>
<td>7.5</td>
<td>1,310,258</td>
<td>34.1</td>
<td>30,745,589</td>
<td>7.8</td>
<td>9,544,915</td>
<td>2.8</td>
<td>15,752,623</td>
<td>10.9</td>
</tr>
<tr>
<td>2011</td>
<td>5,021,536</td>
<td>7.7</td>
<td>1,677,888</td>
<td>20.3</td>
<td>1,336,082</td>
<td>2</td>
<td>33,539,585</td>
<td>9.1</td>
<td>9,632,873</td>
<td>0.9</td>
<td>18,051,346</td>
<td>14.6</td>
</tr>
<tr>
<td>2012</td>
<td>5,270,169</td>
<td>5.0</td>
<td>1,316,763</td>
<td>-21.5</td>
<td>1,169,968</td>
<td>-12.4</td>
<td>36,361,144</td>
<td>8.4</td>
<td>10,271,609</td>
<td>6.6</td>
<td>19,244,045</td>
<td>6.6</td>
</tr>
<tr>
<td>2013</td>
<td>5,718,206</td>
<td>8.5</td>
<td>2,018,929</td>
<td>53.3</td>
<td>1,758,663</td>
<td>50.3</td>
<td>37,666,141</td>
<td>3.6</td>
<td>9,542,592</td>
<td>-7.1</td>
<td>20,750,773</td>
<td>7.8</td>
</tr>
</tbody>
</table>

5-Yr. CAGR: 7.8  
5-Yr. Chg.: 45.3  

Source: A.M. Best data & research
captive anticipates occasional shock losses, so deviations in performance such as Sandy caused in 2012 are expected, but the recovery follows quickly. However, over a five- and certainly a 10-year time horizon, captives have lower loss and LAE ratios compared with commercial lines.

The typical invested asset allocation for this group of captives consisted of approximately 47% long-term bonds, 13% equities, 9% cash and short-term investments, and 31% other assets that included affiliated investments, real estate and select sophisticated derivative instruments (see Exhibit 5). Most captives had minimal other investments, and a few large group captives and single-parent captives were responsible for the other asset contributions. It should be noted that affiliated investments were 9% of invested assets in 2013. As previously mentioned, single-parent captives utilize loan-backs from their parents, which house the expertise and sophisticated investment management.

In 2013, captives' portfolios generated net investment income of $785 million, which represents an increase of $21 million, or 2.7%, compared with 2012. This group of captives generated realized capital gains of $282 million during 2013, which was an increase of $39 million, or 16%, over 2012. The primary source of realized capital gains was fixed-income investments.

Exhibit 6 shows five-year pure net loss experiences by product line. Commercial multiperil and private passenger auto liability are the two lines consistently showing unfavorable results, although on average, all lines performed better than the industry composite. As can be seen, commercial multiperil suffered a huge spike in its pure net loss ratio for 2012, mainly because of Sandy. In medical professional liability, the better performance over five years mainly reflected
important new initiatives in patient safety and risk management that captives gradually established. Other contributing factors included lowering of limits, retaining smaller exposures, increasing rates and shedding some unprofitable businesses; all these measures combined contributed to the strong performance of this line of business.

**Leverage**

The rated captives wrote $5.7 billion of premium for 2013 on a surplus base of $20.8 billion, resulting in a premium-to-surplus ratio of 0.3 to 1 (see Exhibit 7). This compares favorably with the commercial composite of 0.8 to 1. In like fashion, insurance liability leverage for the captives in 2013 was 0.8 to 1, compared with the commercial composite’s leverage of 2.2 to 1, pointing to the conservatism of captives in reserving and the captives’ focus on risk management and mitigation. Finally, ceded leverage for captives was 0.3 to 1, while for the commercial sector it was 0.8 to 1.

**Liquidity**

Liquidity for the captive composite continued to be strong, with 2013 quick and current liquidity measures of 57.6% and 187.5%, respectively. This compares very favorably with the commercial casualty composite, which had corresponding 2013 measures of 22% and 109.5%, respectively. Captives’ 2013 underwriting and operating cash flows were also strong at 100.9% and 117.4%, respectively.

**Market Conditions**

A.M. Best has noticed significant changes in the captive marketplace over the past decade. Before 2000, the captive cycle followed the underwriting cycle for the commercial lines industry. Specifically, in hard markets for commercial insurers, businesses formed and increased their use of captives to insulate themselves against steep, short-term price increases that would last a few years. Then, as commercial insurance rates declined, captives would be run off or downsized in response to
the relatively inexpensive rates available in the conventional market.

Over the past decade, captives have found a permanent place in U.S. corporations’ risk management strategies. Analysts are told that “corporate memories” are longer, and companies use their captives not in response to the commercial underwriting cycle, but to insulate themselves against it by hedging volatile rates and changes in coverage. Some captives rated by A.M. Best have replaced the commercial insurer altogether and cede directly to the commercial reinsurance market. At the same time, some captives are either currently writing or contemplating adding certain benefits lines (long-term disability, for example) that commercial insurers traditionally have written.

A number of states have approved or revitalized and updated their captive legislation, such that more than 35 states now have approved or pending captive legislation. This has led to robust competition among domestic domiciles that could lead to less rigorous regulation. This would not only be detrimental for the new domiciles, but it could have a negative influence on established captive domiciles, since as one prominent captive manager puts it, “we are all painted with the same brush.”

Exhibit 8
U.S. Captive Insurance – Asset Composition
(USD Thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>Long-Term Bonds</th>
<th>Preferred Stocks (%)</th>
<th>Common Stocks (%)</th>
<th>Total Stocks</th>
<th>Real Estate &amp; Mortgage</th>
<th>Cash &amp; Equivalents</th>
<th>Short-Term Investments</th>
<th>Other Invested Assets</th>
<th>Non-Affiliated Invested Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>13,830,395</td>
<td>1.9</td>
<td>98.1</td>
<td>2,932,662</td>
<td>12,039</td>
<td>1,404,217</td>
<td>1,011,030</td>
<td>5,645,797</td>
<td>24,836,139</td>
</tr>
<tr>
<td>2010</td>
<td>14,779,938</td>
<td>1.1</td>
<td>98.9</td>
<td>3,290,194</td>
<td>15,697</td>
<td>1,784,626</td>
<td>999,731</td>
<td>6,070,070</td>
<td>26,940,255</td>
</tr>
<tr>
<td>2011</td>
<td>15,224,079</td>
<td>1.1</td>
<td>98.9</td>
<td>3,179,738</td>
<td>13,803</td>
<td>1,917,236</td>
<td>795,671</td>
<td>6,601,375</td>
<td>27,731,903</td>
</tr>
<tr>
<td>2012</td>
<td>15,535,759</td>
<td>0.9</td>
<td>99.1</td>
<td>3,745,837</td>
<td>13,715</td>
<td>2,115,637</td>
<td>757,290</td>
<td>7,199,625</td>
<td>29,367,863</td>
</tr>
<tr>
<td>2013</td>
<td>15,701,222</td>
<td>0.6</td>
<td>99.4</td>
<td>4,410,775</td>
<td>8,294</td>
<td>2,047,766</td>
<td>850,083</td>
<td>7,485,733</td>
<td>30,503,874</td>
</tr>
</tbody>
</table>

Source: A.M. Best data & research

While it makes sense to have competition and choice, A.M. Best is concerned that the number of possible captive domiciles will introduce a level of competition that would foster a more lax regulatory environment. Also, if a domicile has a limited number of captives, is it really a captive domicile? Surely, a certain volume of captives is needed to support investment in a robust infrastructure of actuaries, accountants, captive managers and attorneys. These resources, forming local associations and working with regulators, have proved to be effective in helping domiciles to flourish. Only time will tell the result of this unprecedented competitive dynamic among domiciles.

Exhibit 9
U.S. Captive Insurance – Asset Allocation
Percentage of total admitted assets.

<table>
<thead>
<tr>
<th>Year</th>
<th>Long-Term Bonds</th>
<th>Total Stocks</th>
<th>Real Estate &amp; Mortgages</th>
<th>Short-Term Investments &amp; Cash</th>
<th>All Other</th>
<th>Non-Affiliated Invested Assets</th>
<th>Affiliated Invested Assets</th>
<th>Total Invested Assets</th>
<th>Agents &amp; Premium Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>In Course of Collection</td>
</tr>
<tr>
<td>2009</td>
<td>48.5</td>
<td>10.3</td>
<td>-</td>
<td>8.5</td>
<td>19.8</td>
<td>87.1</td>
<td>2.5</td>
<td>89.6</td>
<td>1.7</td>
</tr>
<tr>
<td>2010</td>
<td>48.1</td>
<td>10.7</td>
<td>0.1</td>
<td>9.1</td>
<td>19.7</td>
<td>87.6</td>
<td>2.5</td>
<td>90.2</td>
<td>1.8</td>
</tr>
<tr>
<td>2011</td>
<td>45.4</td>
<td>9.5</td>
<td>-</td>
<td>8.1</td>
<td>19.7</td>
<td>82.7</td>
<td>7.5</td>
<td>90.2</td>
<td>1.9</td>
</tr>
<tr>
<td>2012</td>
<td>42.7</td>
<td>10.3</td>
<td>-</td>
<td>7.9</td>
<td>19.8</td>
<td>80.8</td>
<td>7.4</td>
<td>88.2</td>
<td>2.7</td>
</tr>
<tr>
<td>2013</td>
<td>41.7</td>
<td>11.7</td>
<td>-</td>
<td>7.7</td>
<td>19.9</td>
<td>81.0</td>
<td>8.0</td>
<td>89.0</td>
<td>2.8</td>
</tr>
<tr>
<td></td>
<td>Industry</td>
<td>60.6</td>
<td>4.4</td>
<td>1.1</td>
<td>3.0</td>
<td>4.8</td>
<td>73.9</td>
<td>9.7</td>
<td>83.8</td>
</tr>
</tbody>
</table>

Source: A.M. Best data & research

RRGs Continue to Outperform Their Commercial Peers
Since Congress passed the Liability Risk Retention Act in 1986 to help U.S. businesses and professionals to obtain affordable liability insurance, the growth of risk retention groups (RRGs) – i.e., companies formed by trade and professional associations to serve their respective groups’ liability insurance programs – have continued to flourish. The total number of RRGs as of the end of June 2014 was 239, according to Risk Retention Reporter. RRGs are licensed in at least one state but have authority to operate in all, writing various liability lines, excluding workers’ compensation.
A.M. Best has rated RRGs since the early 1990s. Most of these originally rated companies thrive to this day. They have progressed from an unfamiliar type of organization that initially may have confused potential insureds, to long-standing, member-driven companies. They operate either as stand-alone operations or as part of larger groups that offer a variety of other insurance products and services. One thing that has been evident to A.M. Best analysts has been the rated RRGs’ results. The focused approach has resulted in aggregate operating results that consistently outperform a peer group of commercial casualty writers. A.M. Best currently rates 43 RRGs, with more expected by year-end 2014. The statistics in this report reflect the results of this universe of rated RRGs. It should be noted that within this universe, for 2009-2013, more than $638 million of surplus buildup and dividends that otherwise would have gone to commercial insurers were retained by the RRGs and/or returned to their members.

Admitted assets and policyholders’ surplus at Dec. 31, 2013 continued to increase compared with Dec. 31, 2012, by 1.8% and 3.3%, respectively. Surplus for the group was approximately $1.9 billion at year-end 2013 (see Exhibit 11).

Results

As seen in Exhibit 12, all of the five-year average performance metrics continue to significantly outperform those of A.M. Best’s Commercial Casualty Composite, which was used for this comparison.

The many reasons for this performance include low retentions, prudent and active management and mitigation of losses, and implementation of robust risk management practices among the members. As can be seen, policyholder dividends are relatively larger for RRGs than for commercial insurers. While many observers may consider the dividend as a negative, it is actually a positive, as it is paid to the RRG members. This is clearly a retention tool – a member awarded for its performance is much more apt to renew its policy. While the aggregate statistics are unavailable, many of the rated RRGs have policyholder retention exceeding 90% annually.

The RRG universe analyzed for this report maintains very sound liquidity as measured by the various liquidity ratios, which remain better than those of the commercial casualty insurers and in fact surpass the commercial insurers by wide margins, as shown in Exhibit 13.

Consistent with prior years, reserve redundancies continued to be in the teens and 20s, averaging 16.6% over the past five years and pointing to the fact that RRGs in general set their loss reserves very conservatively. This conservative tack is a reflection of the member-driven operating philosophy and

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**Exhibit 10**

Risk Retention Groups – Domicile Distribution of A.M. Best-Rated RRGs

**Exhibit 11**

Risk Retention Groups – Admitted Assets & Surplus of A.M. Best-Rated RRGs

**Exhibit 12**

Risk Retention Groups – Key Ratios vs. Commercial Composite, 2009-2013 (%)

<table>
<thead>
<tr>
<th>Ratio</th>
<th>RRGs</th>
<th>Commercial Composite</th>
<th>Variance Favorable/Unfavorable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss &amp; Loss-Adjustment Expense</td>
<td>55.7</td>
<td>72.6</td>
<td>16.9</td>
</tr>
<tr>
<td>Underwriting Expense</td>
<td>26.1</td>
<td>30.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Combined (Before Policyholder Dividends)</td>
<td>81.8</td>
<td>102.9</td>
<td>21.1</td>
</tr>
<tr>
<td>Policyholder Dividends</td>
<td>4.4</td>
<td>0.3</td>
<td>(4.1)</td>
</tr>
<tr>
<td>Combined (After Policyholder Dividends)</td>
<td>86.2</td>
<td>103.2</td>
<td>17.0</td>
</tr>
<tr>
<td>Net Investment</td>
<td>16.0</td>
<td>14.9</td>
<td>1.1</td>
</tr>
<tr>
<td>Operating</td>
<td>70.2</td>
<td>88.3</td>
<td>18.1</td>
</tr>
</tbody>
</table>

**Exhibit 13**

Risk Retention Groups – Liquidity vs. Commercial Composite, 2009-2013 (%)

<table>
<thead>
<tr>
<th>Ratio</th>
<th>RRGs</th>
<th>Commercial Composite</th>
<th>Variance Favorable/Unfavorable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quick Liquidity</td>
<td>53.6</td>
<td>22.0</td>
<td>31.6</td>
</tr>
<tr>
<td>Current Liquidity</td>
<td>169.6</td>
<td>109.5</td>
<td>60.1</td>
</tr>
<tr>
<td>Operating Cash Flow</td>
<td>140.8</td>
<td>117.5</td>
<td>23.3</td>
</tr>
</tbody>
</table>

Source: A.M. Best data & research
the longer tailed lines of business written by the RRGs. Aggregated premiums written for the 43 RRGs in 2013 consisted of medical professional liability (44.9%), other liability (51.5%) and commercial auto liability (2.8%).

Furthermore, the RRGs maintained excellent overall risk-adjusted capitalization, as measured by Best’s Capital Adequacy Ratio (BCAR) (see Exhibit 14). While at year-end 2013, the BCAR for the commercial composite was 243.7%, the RRGs’ BCAR was 427.1%. This comparative improvement is mainly due, among other things, to more profitability resulting in internally generated surplus.

As A.M. Best previously stated, younger and smaller RRGs that were formed during hard market cycles – and face the re-entry of the commercial segment into their markets – are likely under the most pressure, leading to potential changes in legal structure or even some organized run-offs. However, A.M. Best feels that with solid membership trends, outstanding performance, and members’ recognition of the benefits of solid risk management, the rated segment will continue to thrive. Exhibit 15 shows A.M. Best’s current distribution of letter-rated RRGs. These companies tend to maintain ratings in the A and A- range because managements maintain strong capitalization, consistently solid operating performance and outstanding member retention.

### Exhibit 14
**Risk Retention Groups – BCAR* vs. Commercial Composite**

<table>
<thead>
<tr>
<th>Year</th>
<th>RRGs</th>
<th>Commercial Composite</th>
<th>Variance Fav/(Unfav)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>427.1</td>
<td>243.7</td>
<td>183.4</td>
</tr>
<tr>
<td>2012</td>
<td>415.8</td>
<td>222.6</td>
<td>193.2</td>
</tr>
</tbody>
</table>

* Best’s Capital Adequacy Ratio
Source: A.M. Best data & research

### Exhibit 15
**Risk Retention Groups – A.M. Best Rating Distribution**

Source: A.M. Best data & research

### Rated Single-Parent Captives Continue to Perform Well

Increasing surpluses and dividend payments over the years provide a measure of the utility and acceptability of single-parent captives to their parents. Between 2009 and 2013, the surplus in A.M. Best’s universe of U.S.-domiciled, single-parent captives increased to $8.6 billion from $6.3 billion; the amount of dividends paid to parents during this five-year period was $2.2 billion. Therefore, at least during the past five years, $4.5 billion of premiums that could have been spent on commercial insurers remained within the organizations of the captives and their parents.

### Exhibit 16
**U.S. Single-Parent Captives – A.M. Best-Rated Companies by Industry, 2013**

Source: A.M. Best data & research
As of year-end 2013, A.M. Best has ratings on 60 single-parent captives, compared with 51 in 2012, from its offices in the United States, the United Kingdom and Hong Kong. Of this number, 47% are U.S. domiciled (Vermont, Michigan, South Carolina, Iowa, Texas and New York), and the remainder (53%) are in various other domiciles (Bermuda, Cayman Islands, Germany, Luxembourg, etc.). Since these captives insure their parents’ risks, their industry diversification is identical to those of their parents. Exhibit 16 shows such diversification in A.M. Best’s single-parent captive universe. The top three industry sectors within the universe of A.M. Best-rated captive companies are oil and support industries (16.7%), energy industry (11.7%) and financial services (10.0%), which rely more heavily on ratings because of larger policy limits, greater captive retentions and dependence on reinsurance. Construction, chemical, retail, automakers, human services and manufacturing are among other industries with rated captives. In addition to compliance with regulatory and transparency regimes, ratings provide owners with greater flexibility and efficiencies, as well as enhancing their risk management.

These captives bring many unique attributes due to their relationship with their owners, as the parent knows the captive’s risks and how to mitigate them, and the captive manages these risks and their mitigation more efficiently than many commercial insurers could. This knowledge of risk continues to shine a positive light on the segment.

While the following tables and discussions highlight the results of the U.S.-rated single-parent captive sector, many of the observations also apply to A.M. Best-rated international single-parent captives as well. Exhibit 17 shows the various lines of businesses these U.S. captives write based on net premiums written (NPW).

Comparing Single-Parent Captives and Commercial Lines:

As Exhibit 18 shows, single-parent captives continue to outperform the commercial industry in terms of profitability by substantial margins. The loss and loss-adjustment expense (LAE) ratio, lower frequency and severity of losses and significantly lower claims-mitigation costs are the main factors in the 15% favorable variance. Losses are less frequent because of the captives’ proactive and customized loss-control programs that are designed to concentrate on risk areas that are relevant to the business, as opposed to the generalist approach that most commercial insurers undertake. Another reason for lower frequency of losses is the feedback loop involving a single-parent captive’s underwriting, claims and loss-control areas that analyze losses and design ways to eliminate or minimize them in the future. This sustains superiority over commercial insurers, which often have difficulty communicating similar messages to their policyholders and in many cases, minimal interaction between claims and underwriting.

Exhibit 18
U.S. Single-Parent Captives – Key Ratios vs. Commercial Composite, 2009-2013 (%)

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Single-Parent Captives</th>
<th>Commercial Composite</th>
<th>Variance Favorable/(Unfavorable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss &amp; Loss-Adjustment Expense</td>
<td>58.2</td>
<td>73.2</td>
<td>15.0</td>
</tr>
<tr>
<td>Underwriting Expense</td>
<td>5.8</td>
<td>28.1</td>
<td>22.3</td>
</tr>
<tr>
<td>Combined (Before Policyholder Dividends)</td>
<td>64.0</td>
<td>101.3</td>
<td>37.3</td>
</tr>
<tr>
<td>Policyholder Dividends</td>
<td>10.7</td>
<td>11.2</td>
<td>(0.5)</td>
</tr>
<tr>
<td>Combined (After Policyholder Dividends)</td>
<td>53.3</td>
<td>90.1</td>
<td>36.8</td>
</tr>
<tr>
<td>Net Investment</td>
<td>14.8</td>
<td>15.6</td>
<td>(0.8)</td>
</tr>
<tr>
<td>Operating</td>
<td>52.5</td>
<td>87.9</td>
<td>35.4</td>
</tr>
</tbody>
</table>

Source: A.M. Best data & research

The underwriting expense ratio shows a 22.3% favorable variance with commercial insurers’ results. This reflects the elimination of agency and brokerage costs, as well as lower overhead, marketing, and business development and legal expenses. More important, it is due to single-parent captives’ tendency toward lower costs, mainly in the areas of LAE and...
The overall profitability of single-parent captives, combined with their ability to generate capital internally, allows them to provide their parents with dividends without any negative impact on the captive's surplus. Therefore, it is not surprising to see the significant expansion of single-parent captives over the past half century. For most large and medium-sized corporations, having a captive is no longer an option but rather a necessity, since greater control and cost savings have been evident for years. Risk managers have become more prevalent and are replacing or augmenting CFOs in buying insurance and reinsurance. It is a nuanced buy, using the captive and commercial markets strategically. Retentions are adjusted at the captive accordingly. Lines of business may be placed in the commercial market, then shifted to the captive as it develops the acumen necessary to support the line.

The net investment income ratio, on average, is fairly comparable between single-parent captives and commercial lines, mainly reflecting the low interest rate environment of the overall economy. In the past, this ratio was higher for single-parent captives, mainly because of (1) the use of interest-bearing loan-backs that had interest rates between 5% and 10%, depending on the parent's cost of capital; and (2) the captives' relatively robust capitalization, which led to a higher invested asset base that partially experiences the same depressed yield environment as commercial insurers do.

The single-parent captive universe analyzed for this report maintains stronger liquidity, as measured by the various liquidity ratios, than the commercial composite (see Exhibit 19). Furthermore, single-parent captives maintained excellent overall risk-adjusted capitalization, as measured by Best's Capital Adequacy Ratio (BCAR) (see Exhibit 20). These captives recorded greater profitability and internally generated surplus and lower weather-related losses in 2013 than their commercial property peers.

A.M. Best recognizes that single-parent captives maintain relatively stable ratings, despite being occasionally subject to relatively large losses. These captives are in the shock-loss businesses and largely do an excellent job in managing these exposures. While the net retained limits to surplus sometimes appear high, who better to monitor safety standards and loss control than the company itself? What once was just an instrument for lower premiums during hard markets now has become a consistent risk management tool used in all market cycles.

Exhibit 19 shows A.M. Best’s current ratings distribution of both U.S. and non-U.S. single-parent captives. These companies tend to maintain ratings in the A and A- range because of consistently solid operating performance resulting in strong risk-adjusted capitalization. These measures allow captives to achieve the rating levels necessary for the
requirements of their lines of business and licensing, and to meet approval standards from third parties that are imposed on these companies.

Cybersecurity Risk
There is a significant increase in businesses falling victim to cybersecurity risks of all sorts, as more losses have been reported along these lines. Businesses are victimized by cyberspace fraudsters who gain access to customers’ vital information, including bank account and credit card information, in order to drain them. During the past several years, disruption of websites by hackers has been increasingly common, causing business interruptions and dissatisfaction among users and customers.

With the advance of technology to allow people to conduct a good portion of their daily life (purchases, banking, etc.) via the Internet and online services, and with the availability of some key personal information in different social media venues, both people and businesses are exposed to cyber risk and data breaches that could cost several hundred millions if not billions of dollars. Too often, cyber risk management is left to information technology (IT) departments because they are overly protective of what they see as their domain. But risk managers are urged to move aggressively and explore government-led initiatives to get on top of this growing threat.

A.M. Best routinely asks rated captives about their cyber security risk exposure and risk mitigation measures. While some of this risk may be unavoidable, regardless of how strong a company’s risk management is, the rated captives in general have taken an active role to minimize this risk. For the majority of A.M. Best-rated captives, this issue is regularly a topic of ERM Committee meetings, with some companies even dedicating a cyber-risk security department to regularly upgrade and test systems.

Legal Environment
The formation of RRGs, which was promoted by the federal Liability Risk Retention Act of 1981 and amended under the Liability Risk Retention Act of 1986 (LRRA), has been a very successful program mainly because of members’ strong and active participation in governance and risk management of the RRGs. These entities currently are limited to offering liability insurance, and given the knowledge and expertise in their respective industries – coupled with the limited scope of their coverage – RRGs practice effective and successful risk and claims management on behalf of their member insureds.

For several years now, there has been support for and limited opposition to certain amendments to the LRRA, including legislation that would allow RRGs to sell commercial property insurance. These amendments have not been acted upon during the past several years. However, they may gain new traction following some technical corrections to the Risk Retention Modernization Act of 2014, a yet to be filed measure that would expand LRRA to allow RRGs to write commercial property insurance. A new provision has been added that would require the Government Accountability Office (GAO) to examine whether there is unlawful interference in the operation of RRGs by non-domiciliary regulators. Pamela E. Davis, founder, president and chief executive officer of Alliance of Nonprofits for Insurance, Risk Retention Group, commented that “probably our most significant challenge remains the inability of RRGs to write property. For nonprofits, in particular, purchasing a package policy from us that includes property would be the most efficient solution.” Similar sentiments exist with other large group captives.

On another front, while the Dodd-Frank Act is a very important matter for the captive industry, the RRG industry has had the foresight to obtain an exemption from this legislation.

The National Association of Insurance Commissioners (NAIC) continues to be very active in RRG regulation, requiring the RRG states of domicile to comply with various NAIC model laws and regulations through the state accreditation process. State accreditation is a certification given to a state insurance department once it demonstrates that it has met and continues to meet an assortment of legal, financial and organizational standards as determined by a committee of its peers. While the process could be challenging for RRGs, the mission of the NAIC’s accreditation program is to establish and maintain standards to promote sound financial solvency regulation.

Wadsworth v. Allied Professional
States continue to test the boundaries of the LRRA. In April 2014, however, the 2nd Circuit Court of Appeals in New York issued a decision with far-reaching positive implications for RRGs in a 4-year-old case involving a victim of sexual abuse against Allied Professionals Insurance Co. (APIC).
The case involves APIC’s denial of renewal of coverage to a chiropractor, who failed to disclose that he had sexually molested one of his patients. The patient secured a judgment against the chiropractor and proceeded to file suit against APIC under the direct-action statute to enforce the judgment. APIC removed the case to federal court after several years and won the case in a summary judgment. The plaintiff took the case to the Circuit Court of Appeals. The National Risk Retention Association (NRRA) filed a declaration in the underlying case, then filed an amicus brief in support of APIC, invoking the LRRA to argue against improper legislation or rule making.

The case in question arose from an attempt to enforce a direct-action statute against APIC, whose position was that under LRRA, a state such as New York cannot apply such a statute to an RRG that is not domiciled in New York. APIC is domiciled in Arizona but has more than 4,000 insureds in New York.

In his opinion upholding the District Court judgment, Circuit Court Judge Gerard Lynch wrote: “The federal Liability Risk Retention Act of 1986 contains sweeping preemption language that sharply limits the authority of states to regulate, directly or indirectly, the operation of risk retention groups chartered in another state.” The decision underscores the congressional intent that the LRRA was created specifically to pre-empt the majority of state activities and can be used in other cases involving existing state laws, proposed legislation and regulatory violations.

Vermont’s LIMA Legislation

In February 2014, Vermont’s Legislature enacted the Legacy Insurance Management Act, the first of its kind, which enables the transfer of closed books of commercial insurance and reinsurance policies by creating a legal and regulatory framework and marketplace for such transfers. LIMA was championed by Anna Petropoulos, president of Apetrop USA. Under this new framework, if a European insurer desires to divest itself of its portfolio of legacy U.S. liabilities, an Arizona company that is interested in buying this portfolio could establish an entity in Vermont and proceed with the transfer of that business. Since the blocks of policies involved are closed, the buyer need not be active as an insurance company. Investors may include those with long investment horizons such as foundations, institutional endowments and family trusts.

LIMA enables a nonadmitted insurer from any part of the world to transfer closed blocks of business - commercial insurance policies and/or reinsurance agreements protecting underlying U.S. liabilities that have continued exposure to claims – to an admitted insurer or other entity domiciled in Vermont, which then takes over the obligations to policyholders. Neither personal lines such as life, health, auto or homeowners, nor workers’ compensation, are involved. The act provides regulatory oversight by Vermont’s Department of Financial Regulation (DFR) of both the transaction and claims management of the transferred business.

TRIA/TRIPRA Renewal

On June 20, 2014, the House Financial Services Committee approved by a 32-27 vote legislation to bring much-needed reforms to the Terrorism Risk Insurance Act (TRIA) and to extend the federal terrorism insurance program for another five years. The Senate version of the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA), which was passed unanimously in July, would extend the program for seven years. The House bill differentiates between conventional terrorist attacks and nuclear, biological, chemical or radiological (NBCR) attacks. Beginning Jan. 1, 2016, the trigger for tapping the program after conventional attacks would increase $100 million per year up to $500 million. Meanwhile, the trigger for NBCR attacks would remain at the current $100 million. The Senate bill makes no change to the trigger, regardless of the nature of the terrorist attack. Also starting Jan. 1, 2016, the House legislation would reduce the federal share of payments for losses from conventional terrorist attacks to 80% of insured losses by 2019, the same percentage included in the Senate bill. Under the House bill, however, the federal share for NBCR attacks would remain at 85% of insured losses. The insurance industry prefers the Senate version, and the chambers are expected to reach a compromise.
Japanese-owned captive insurers remain a small fraction of the total number of captives globally, despite Japan’s position as the world’s third-largest economy and the second largest in the Asia-Pacific region. The number of captives owned by Japanese companies is estimated at as many as 100 out of about 6,000 worldwide, and approximately one-fifth of the listed companies in the Nikkei 225 index operate captives.

The reasons for the less-developed captive market are varied, with the most significant being the close relationship between Japan’s insurance companies and industrial groups. Although insurers have been reducing stock investments over the past 10 years as a way of improving enterprise risk management (ERM), non-life insurers have been large shareholders of Japanese industrial groups. Total asset size of the non-life insurance industry reached JPY 28.5 trillion as of March 2013. Sales of long-term maturity refund insurance enabled non-life insurers to accumulate sizable amounts of assets during the period (see Exhibit 1).

The three major non-life insurance groups that actively provide corporate insurance programs account for around 87% of non-life premium income and retain around 90% of risks in Japan (or 77% of non-auto risks). In particular, the three insurance groups’ retention in the marine cargo line is about 90%, which presents a small opportunity for captive coverage. Regardless, marine cargo is the line most often underwritten by Japanese captives (see Exhibit 2).

In addition, the small presence of the broker market in Japan (less than 0.5% of the non-life industry’s gross premiums written [GPW] is generated by the broker channel) indicates a limited opportunity for Japanese industrial companies to access information and know-how about captive operations.

The comparatively low number of captives in Japan versus the Western market also is driven by the classes of business written in the Japanese non-life market (see Exhibit 3). Japan’s liability insurance market remains small relative to the Western market – in particular the U.S. market, where liability accounts for nearly half of the industry’s annual net premiums written (NPW). As an example, the government in Japan covers some risks such as workers’ compensation, while workers’ comp in the United States is fully employer-funded through either commercial insurance or self-insurance.
In this respect, prospects for growth of the Japanese captive market are mixed. A strong near-term increase in the number of new Japanese captives is not likely. However, captives’ role in Japanese companies is expected to develop gradually, based on recent observations of both rated and non-rated captives owned by Japanese companies, as well as discussions with market participants such as multinational brokers. It is highly unlikely, though, that they will ever reach a size comparable to what is seen in the West, particularly the United States.

Profile of Japan Captive Operations
Fronting is common among Japanese captives, which assume the parent company’s risks from insurance and reinsurance companies instead of writing the parent company’s risks directly. In general, when ceding the parent companies' risks to their captives, insurers put more emphasis on evaluating the parent companies’ credit risk or collateral provided by the parent companies than on evaluating the captives’ credit ratings. It explains relatively low demand for credit ratings among Japanese captives, which is in line with a very small percentage of global captives being rated. Also, the current risk-based capital regime in Japan does not differentiate counterparty risk by credit ratings.

Single-parent structures remain the predominant form for Japanese captives. Japanese parent companies’ businesses are well diversified, with manufacturing and energy businesses relatively active in operating captives (see Exhibit 4).

A single-parent captive’s priority is to meet the parent’s specific insurance needs, which differ by industry. Marine cargo risk appears to be most often underwritten by Japanese captives in manufacturing and trading businesses. Also, a few captives owned by Japanese trading companies (including the highly diversified sogo shosha organizations) are writing third-party risks, mainly from the businesses or joint-venture projects in which they have ownership.

In principle, the market profile of captives is factored into the rating analysis. Most captives, especially single-parent captives, have a limited market profile compared with commercial insurers, as they serve certain needs of their parents. Hence, the relationship between the captive and the insured parent company is incorporated to evaluate the captive’s market profile (see A.M. Best’s Criteria Report Alternative Risk Transfer [ART], published Dec. 27, 2011). The rating review processes differentiate the captives' businesses profile by insurance coverage, risk retention, loss control and risk management, which varies with the nature of the parent company’s businesses. Indeed, support the captive

Exhibit 3

Exhibit 4
Japan Captives – Parent Company Distribution by Industry

Source: Mainichi Newspapers, A.M. Best data & research
receives from the parent company is incorporated into the credit rating review process. It also indicates that deterioration of the parent company’s credit profile could have an adverse impact on the single-parent captive’s rating.

Seeking the Best Location
Some captive owners have made innovative use of captives in recent years. Captive owners such as sogo sbosha in Japan consider promoting their captive know-how to customers or various stakeholders through either underwriting customers’ risks or providing captive facilities. Protected cell companies (PCCs) in Bermuda or multiple corporate captives (MCCs) in the Federated States of Micronesia (FSM) are examples of this.

In this respect, the domicile is a key factor for captives’ expansion, as not all domiciles allow underwriting of third-party risk or introduction of cell structures. Bermuda and Hawaii, which have long histories of captive operations, remain the most popular domiciles for Japanese captives. However, a few domiciles in the Asia-Pacific region have gained traction among Japanese captives in the past 10 years. The region’s relatively new captive domiciles have adopted regulatory standards similar to developed domiciles such as Bermuda and Hawaii. Also, geographical proximity and favorable tax schemes in the region have attracted Japanese companies. In particular, appealing domiciles may offer reasonable tax treatment of captives’ income under the parent company’s home country. For example, Singapore had been a popular domicile among Japanese captives because its tax regime was favorable to Japanese companies, particularly regarding the tax-haven rule. The anti-tax-haven rules in Japan call for the income of foreign-affiliated companies to be added into the Japanese parent companies’ income if the effective income tax rate of the foreign domicile is 20% or less. Many Japanese captives have moved out of Singapore since the tax rate was lowered to 17% from 21%.

In contrast, FSM, a relatively new domicile in the Asia-Pacific region, has attracted some Japanese captives in the past five years. FSM has implemented favorable regulations toward Japanese companies by offering usage of Japanese language and Japanese currency in addition to the tax advantage. FSM promptly reduced the tax rate to 21% from 25.5% after Japan’s tax reform in 2010, which included reduction of the trigger tax rate for the anti-tax haven rule to 20% from 25%.

The risks associated with the captive’s domicile are incorporated into the rating review. A.M. Best defines country risk as the risk that country-specific factors could adversely affect an insurer’s ability to meet its financial obligations, and separates the risks into three main categories: economic risk, political risk and financial system risk. The scores of each category of risk are aggregated, and the country is assigned to one of the five Country Risk Tiers (CRT) that range from CRT-1, denoting a stable environment with the least amount of risk, to CRT-5 for countries that pose the most risk and, therefore, the greatest challenge to an insurer’s financial stability, strength and performance. (See A.M. Best’s Criteria Report Evaluating Country Risk, published May 2, 2012.) Exhibit 5 shows the distribution of CRTs of some key captive domiciles. It is worth noting that key elements of country risk can be managed or mitigated in some cases in the rating review of captives. For instance, the actual location of the assets is considered to incorporate country risk into the rating review, which is also relevant to investment risk and liquidity risk.

Captives’ Growing Role
Captive operation is generally recognized as a cost-effective tool for the parent company. Just as important, a captive supplements the group’s risk management needs. The captive provides the owner with flexibility as it pertains to insurance placement. As market conditions allow, an owner may elect to self-insure through the captive or buy from the commercial market.

Until recently, many Japanese captive owners could be seen as not fully benefiting from their captives, given the small amount of retained risk relative to the parent businesses’ size. However, the low retention policy within a certain limit enables captives to report a stable loss history. Furthermore, robust risk management capabilities, including intensive claims analysis and loss-control methods, could help the captives to improve the group’s loss profile, which eventually leads to lower total insurance costs and contributes to improving the group’s risk management function.
As captive owners learned the strategic value of captive operations, they started seeking ways to use captives more fully. This has led to an increase in retentions and expansion of the risk profile in Japanese captive operations, with capital size growing, albeit slowly. It also has led owners to explore various forms of captives to maximize their usage in the group.

**Exhibit 6** shows the rating distribution of rated captives globally as of March 2014.

A.M. Best rates more than 50 single-parent captives. Around half are U.S. domiciled, and the remainder are in various other domiciles (Bermuda, Cayman Islands, Germany, Luxembourg, etc.). While the majority of these captives are in the energy industry (27%) – which relies more heavily on ratings because of larger retentions and dependence on reinsurance – automakers, construction, banking, human services and retail remain among the largest users of ratings as well.

**Observations From Rated Japanese Captives**

Rated Japanese captives account for a small portion of rated captives globally. Hence, observations based on the small number of rated Japanese captives should not be directly applied to the whole Japanese captive industry.

The Japanese ultimate parent companies that own those rated Japanese captives have high profiles in the Japanese and global economies in terms of market share or revenue in their respective industries. The captives write property, liability, marine cargo, warranty and workers’ compensation risks, as well as some casualty lines.

Most rated Japanese captives invest conservatively, focusing mainly on bonds or other liquid assets such as cash and short-term investments. However, among the rated Japanese captives there has been increasing interest in a type of loan-back to the parent company or affiliates. This loan-back concept is familiar to A.M. Best analysts, as it is an accepted practice in many captive domiciles. In essence, the loan back allows a portion (often very significant) to be included in the investment scheme of the parent organization. This allows for stronger oversight and potentially better investment performance as the captive assets are invested by the group that manages all corporate assets. The loan-back to the parent company is charged in Best’s Capital Adequacy Ratio (BCAR) for the captive according to a credit risk factor that considers the credit risk of the parent company. (See the Alternative Risk Transfer [ART] criteria report.) It should be noted that a significant proportion of loan-back in a captive’s invested assets could have a material impact on the captive’s capitalization if the parent’s credit profile remains relatively weak or deteriorates substantially. Rated Japanese captives were generally profitable over the past five years, although the results were volatile during the period. This was caused by catastrophe losses impacting the parent companies, notably Japan’s Tohoku earthquake.

Over the period, rated Japanese captives continued to strengthen their capitalization, mainly through earnings. Retention patterns of earnings were mixed, with some captive insurers retaining all of their net income while others distributed most of it. Capital contributions from the Japanese parent companies were limited, unless designated for certain purposes such as expanding the captive’s business.
A Best’s Financial Strength Rating (FSR) is an independent opinion of an insurer’s financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR 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. An FSR 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.

Best’s Financial Strength Rating (FSR) Scale

<table>
<thead>
<tr>
<th>Rating Categories</th>
<th>Rating Symbols</th>
<th>Rating Notches*</th>
<th>Category Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Superior A+</td>
<td>A++</td>
<td></td>
<td>Assigned to insurance companies that have, in our opinion, a superior ability to meet their ongoing insurance obligations.</td>
</tr>
<tr>
<td>Excellent A</td>
<td>A</td>
<td>-</td>
<td>Assigned to insurance companies that have, in our opinion, an excellent ability to meet their ongoing insurance obligations.</td>
</tr>
<tr>
<td>Good B+</td>
<td>B++</td>
<td></td>
<td>Assigned to insurance companies that have, in our opinion, a good ability to meet their ongoing insurance obligations.</td>
</tr>
<tr>
<td>Fair B</td>
<td>B</td>
<td>-</td>
<td>Assigned to insurance companies that have, in our opinion, a fair ability to meet their ongoing insurance obligations.</td>
</tr>
<tr>
<td>Marginal C+</td>
<td>C++</td>
<td></td>
<td>Assigned to insurance companies that have, in our opinion, a marginal ability to meet their ongoing insurance obligations. Financial strength is vulnerable to adverse changes in underwriting and economic conditions.</td>
</tr>
<tr>
<td>Weak C</td>
<td>C</td>
<td>-</td>
<td>Assigned to insurance companies that have, in our opinion, a weak ability to meet their ongoing insurance obligations. Financial strength is very vulnerable to adverse changes in underwriting and economic conditions.</td>
</tr>
<tr>
<td>Poor D</td>
<td>-</td>
<td></td>
<td>Assigned to insurance companies that have, in our opinion, a poor ability to meet their ongoing insurance obligations.</td>
</tr>
</tbody>
</table>

*Each Best’s Financial Strength Rating Category from “A+” to “C” includes a Rating Notch to reflect a gradation of financial strength within the category. A Rating Notch is expressed with either a second plus “++” or a minus “-“.

FSR Non-Rating Designations

<table>
<thead>
<tr>
<th>Designation Symbols</th>
<th>Designation Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>E</td>
<td>Status assigned to insurance companies that are publicly placed under a significant form of regulatory supervision, control or restraint - including cease and desist orders, conservatorship or rehabilitation, but not liquidation - that prevents conduct of normal ongoing insurance operations; an impaired insurer.</td>
</tr>
<tr>
<td>F</td>
<td>Status assigned to insurance companies that are publicly placed in liquidation by a court of law or by a forced liquidation; an impaired insurer.</td>
</tr>
<tr>
<td>S</td>
<td>Status assigned to rated insurance companies to suspend the outstanding FSR when sudden and significant events impact operations and rating implications cannot be evaluated due to a lack of timely or adequate information; or in cases where continued maintenance of the previously published rating opinion is in violation of evolving regulatory requirements.</td>
</tr>
<tr>
<td>NR</td>
<td>Status assigned to insurance companies that are not rated; may include previously rated insurance companies or insurance companies that have never been rated by AMB.</td>
</tr>
</tbody>
</table>

Rating Disclosure: Use and Limitations

A Best’s Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer’s, issuer’s or financial obligation’s relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance and business profile or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Company Inc. (AMB) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an “as is” basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AMB.

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BEST'S ISSUER CREDIT RATING GUIDE

A Best’s Issuer Credit Rating (ICR) is an independent opinion of an entity’s ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis. A long-term ICR is an opinion of an entity’s ability to meet its ongoing senior financial obligations, while a short-term ICR is an opinion of an entity’s ability to meet its ongoing financial obligations with original maturities generally less than one year. An ICR is an opinion regarding the relative future credit risk of an entity. Credit risk is the risk that an entity may not meet its contractual financial obligations as they come due. An ICR does not address any other risk. In addition, an ICR is not a recommendation to buy, sell or hold any securities, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

Best’s Long-Term Issuer Credit Rating (ICR) Scale

<table>
<thead>
<tr>
<th>Rating Categories</th>
<th>Rating Symbols</th>
<th>Rating Notches*</th>
<th>Category Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceptional</td>
<td>aaa</td>
<td>-</td>
<td>Assigned to entities that have, in our opinion, an exceptional ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Superior</td>
<td>aa</td>
<td>a+, a-</td>
<td>Assigned to entities that have, in our opinion, a superior ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Excellent</td>
<td>a</td>
<td>a+ / a-</td>
<td>Assigned to entities that have, in our opinion, an excellent ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Good</td>
<td>bbb</td>
<td>bbb+ / bbb-</td>
<td>Assigned to entities that have, in our opinion, a good ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Fair</td>
<td>bb</td>
<td>bb+ / bb-</td>
<td>Assigned to entities that have, in our opinion, a fair ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Marginal</td>
<td>b</td>
<td>b+ / b-</td>
<td>Assigned to entities that have, in our opinion, a marginal ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Weak</td>
<td>ccc</td>
<td>ccc+ / ccc-</td>
<td>Assigned to entities that have, in our opinion, a weak ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Very Weak</td>
<td>cc</td>
<td>-</td>
<td>Assigned to entities that have, in our opinion, a very weak ability to meet their ongoing senior financial obligations.</td>
</tr>
<tr>
<td>Poor</td>
<td>c</td>
<td>-</td>
<td>Assigned to entities that have, in our opinion, a poor ability to meet their ongoing senior financial obligations.</td>
</tr>
</tbody>
</table>

*Best’s Long-Term Issuer Credit Rating Categories from “aa” to “ccc” include Rating Notches to reflect a gradation within the category to indicate whether credit quality is near the top or bottom of a particular Rating Category. Rating Notches are expressed with a “+” (plus) or “-” (minus).

Best’s Short-Term Issuer Credit Rating (ICR) Scale

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<th>Rating Symbols</th>
<th>Category Definitions</th>
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<tr>
<td>Strongest</td>
<td>AMB-1+</td>
<td>Assigned to entities that have, in our opinion, the strongest ability to repay their short-term financial obligations.</td>
</tr>
<tr>
<td>Outstanding</td>
<td>AMB-1</td>
<td>Assigned to entities that have, in our opinion, an outstanding ability to repay their short-term financial obligations.</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>AMB-2</td>
<td>Assigned to entities that have, in our opinion, a satisfactory ability to repay their short-term financial obligations.</td>
</tr>
<tr>
<td>Adequate</td>
<td>AMB-3</td>
<td>Assigned to entities that have, in our opinion, an adequate ability to repay their short-term financial obligations; however, adverse industry or economic conditions likely will reduce their capacity to meet their financial commitments.</td>
</tr>
<tr>
<td>Questionable</td>
<td>AMB-4</td>
<td>Assigned to entities that have, in our opinion, questionable credit quality and are vulnerable to adverse economic or other external changes, which could have a marked impact on their ability to meet their financial commitments.</td>
</tr>
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Long- and Short-Term ICR Non-Rating Designations

<table>
<thead>
<tr>
<th>Designation Symbols</th>
<th>Designation Definitions</th>
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</thead>
<tbody>
<tr>
<td>d</td>
<td>Status assigned to entities (excluding insurers) that are in default or when a bankruptcy petition or similar action has been filed and made public.</td>
</tr>
<tr>
<td>e</td>
<td>Status assigned to insurers that are publicly placed under a significant form of regulatory supervision, control or restraint - including cease and desist orders, conservatorship or rehabilitation, but not liquidation - that prevents conduct of normal ongoing operations; an impaired entity.</td>
</tr>
<tr>
<td>f</td>
<td>Status assigned to insurers that are publicly placed in liquidation by a court of law or by a forced liquidation; an impaired entity.</td>
</tr>
<tr>
<td>s</td>
<td>Status assigned to rated entities to suspend the outstanding ICR when sudden and significant events impact operations and rating implications cannot be evaluated due to a lack of timely or adequate information; or in cases where continued maintenance of the previously published rating opinion is in violation of evolving regulatory requirements.</td>
</tr>
<tr>
<td>nr</td>
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</table>

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**BEST’S ISSUE RATING GUIDE**

A Best’s Issue Rating (IR) is an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year). An IR assigned to a specific issue is an opinion of the ability to meet the ongoing financial obligations to security holders when due. As such, an IR is an opinion regarding the relative future credit risk. Credit risk is the risk that an issue may not meet its contractual financial obligations as they come due. The rating does not address any other risk, including, but not limited to, liquidity risk, market value risk or price volatility of rated obligations. The rating is not a recommendation to buy, sell or hold any securities, contracts or any other financial obligations, nor does it address the suitability of any particular financial obligation for a specific purpose or purchaser.

### Best's Long-Term Issue Rating (IR) Scale

<table>
<thead>
<tr>
<th>Rating Categories</th>
<th>Rating Symbols</th>
<th>Rating Notches*</th>
<th>Category Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceptional</td>
<td>aaa</td>
<td>-</td>
<td>Assigned to issues where, in our opinion, there is an exceptional ability to meet the terms of the obligation.</td>
</tr>
<tr>
<td>Superior</td>
<td>aa</td>
<td>aa+ / aa-</td>
<td>Assigned to issues where, in our opinion, there is a superior ability to meet the terms of the obligation.</td>
</tr>
<tr>
<td>Excellent</td>
<td>a</td>
<td>a+ / a-</td>
<td>Assigned to issues where, in our opinion, there is an excellent ability to meet the terms of the obligation.</td>
</tr>
<tr>
<td>Good</td>
<td>bbb</td>
<td>bbb+ / bbb-</td>
<td>Assigned to issues where, in our opinion, a strong ability to meet the terms of the obligation exists.</td>
</tr>
<tr>
<td>Fair</td>
<td>bb</td>
<td>bb+ / bb-</td>
<td>Assigned to issues where, in our opinion, a fair ability to meet the terms of the obligation exists.</td>
</tr>
<tr>
<td>Marginal</td>
<td>b</td>
<td>b+/ b-</td>
<td>Assigned to issues where, in our opinion, a marginal ability to meet the terms of the obligation exists.</td>
</tr>
<tr>
<td>Weak</td>
<td>ccc</td>
<td>ccc+ / ccc-</td>
<td>Assigned to issues where, in our opinion, a weak ability to meet the terms of the obligation exists.</td>
</tr>
<tr>
<td>Very Weak</td>
<td>cc</td>
<td>-</td>
<td>Assigned to issues where, in our opinion, a very weak ability to meet the terms of the obligation exists.</td>
</tr>
<tr>
<td>Poor</td>
<td>c</td>
<td>-</td>
<td>Assigned to issues where, in our opinion, a poor ability to meet the terms of the obligation exists.</td>
</tr>
</tbody>
</table>

*Best’s Long-Term Issue Rating Categories from “aaa” to “ccc” include Rating Notches to reflect a gradation within the category to indicate whether credit quality is near the top or bottom of a particular Rating Category. Rating Notches are expressed with a “+” (plus) or “-” (minus).

### Best's Short-Term Issue Rating (IR) Scale

<table>
<thead>
<tr>
<th>Rating Categories</th>
<th>Rating Symbols</th>
<th>Category Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongest</td>
<td>AMB-1+</td>
<td>Assigned to issues where, in our opinion, the strongest ability to repay short-term debt obligations exists.</td>
</tr>
<tr>
<td>Outstanding</td>
<td>AMB-1</td>
<td>Assigned to issues where, in our opinion, an outstanding ability to repay short-term debt obligations exists.</td>
</tr>
<tr>
<td>Satisfactory</td>
<td>AMB-2</td>
<td>Assigned to issues where, in our opinion, a satisfactory ability to repay short-term debt obligations exists.</td>
</tr>
<tr>
<td>Adequate</td>
<td>AMB-3</td>
<td>Assigned to issues where, in our opinion, an adequate ability to repay short-term debt obligations exists.</td>
</tr>
<tr>
<td>Questionable</td>
<td>AMB-4</td>
<td>Assigned to issues where, in our opinion, a questionable ability to meet financial commitments.</td>
</tr>
</tbody>
</table>

### Long- and Short-Term IR Non-Rating Designations

<table>
<thead>
<tr>
<th>Designation Symbols</th>
<th>Designation Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>d</td>
<td>Status assigned to issues in default on payment of principal, interest or other terms and conditions, or when a bankruptcy petition or similar action has been filed and made public; or where the issuing entity has been designated as impaired (ICR) or E/F (FSR) designation).</td>
</tr>
<tr>
<td>s</td>
<td>Status assigned to rated issues to suspend the outstanding IR when sudden and significant events have occurred and rating implications cannot be evaluated due to a lack of timely or adequate information; or in cases where continued maintenance of the previous published rating opinion is in violation of evolving regulatory requirements.</td>
</tr>
<tr>
<td>nr</td>
<td>Status assigned to issues that are not rated; may include previously rated issues or issues that have never been rated by AMB.</td>
</tr>
</tbody>
</table>

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### BEST’S NATIONAL SCALE RATING GUIDE

A Best’s National Scale Rating (NSR) is a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global Issuer Credit Rating (ICR) using a transition chart. An NSR is only comparable to other NSRs within the same country, as denoted by the specific country code suffix (".XX") attached to each NSR, and not across countries; therefore, impairment statistics cannot be compared directly to a national rating. However, since the global rating is assigned as the base for the national rating, impairment rates can be inferred. In cases where one global ICR level maps to more than one NSR level, a rating committee will determine which level, in accordance with the mapping, is appropriate given the relative financial strength of the entity to meet senior financial obligations. The ICR to NSR mapping chart and other relevant information can be found in the corresponding criteria titled “A.M. Best Ratings on a National Scale” available on the A.M. Best website.

### Best’s National Scale Rating (NSR) Scale

<table>
<thead>
<tr>
<th>Category</th>
<th>Rating Symbols</th>
<th>Category Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exceptional</td>
<td>aaa.XX</td>
<td>Assigned to entities that, in our opinion, an exceptional ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Superior</td>
<td>aa.XX</td>
<td>Assigned to entities that, in our opinion, a superior ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Excellent</td>
<td>a.XX</td>
<td>Assigned to entities that, in our opinion, an excellent ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Good</td>
<td>bbb.XX</td>
<td>Assigned to entities that, in our opinion, a good ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Fair</td>
<td>bb.XX</td>
<td>Assigned to entities that, in our opinion, a fair ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Marginal</td>
<td>b+.XX, b-.XX</td>
<td>Assigned to entities that, in our opinion, a marginal ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Weak</td>
<td>ccc.XX</td>
<td>Assigned to entities that, in our opinion, a weak ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Very Weak</td>
<td>cc.XX</td>
<td>Assigned to entities that, in our opinion, a very weak ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
<tr>
<td>Poor</td>
<td>c.XX</td>
<td>Assigned to entities that, in our opinion, a poor ability to meet their ongoing senior financial obligations relative to other national entities.</td>
</tr>
</tbody>
</table>

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