AM Best
August 2021
Captive Markets

Single-Parent and Group Captives, Risk Retention Groups and Protected Cell Captives

AM BEST SINCE 1899 ®

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Please note that the contents of this booklet are as of August 2021. All report content is subject to change.
Please visit www.ambest.com/ratings for the most current reports and other rating information.

About AM Best

Founded in 1899, AM Best is the world's largest credit rating agency specializing in the insurance industry and insurance-linked securities. Best's Credit Ratings are an assessment of an insurer's financial strength, creditworthiness and their ability to honor obligations to policyholders.

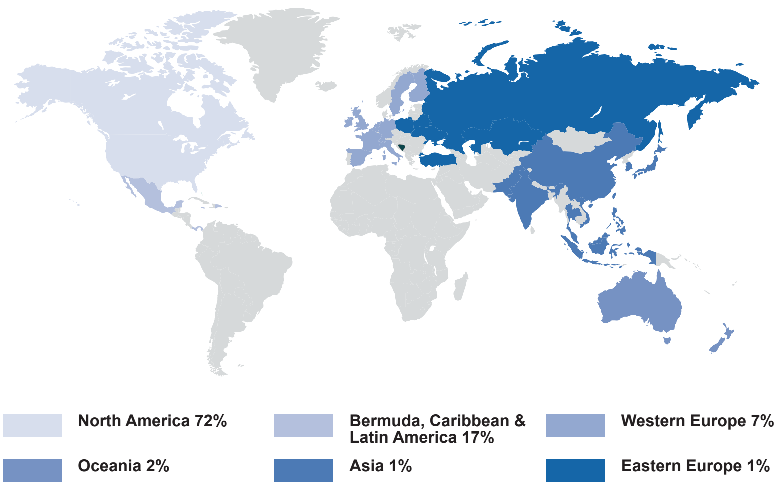
Best's Credit Rating Methodology (BCRM) and Alternative Risk Transfer (ART) criteria for captives provide a comprehensive, transparent explanation of the captive rating process, and our analysts have a deep knowledge of captives and how they are different from standard commercial insurance companies.

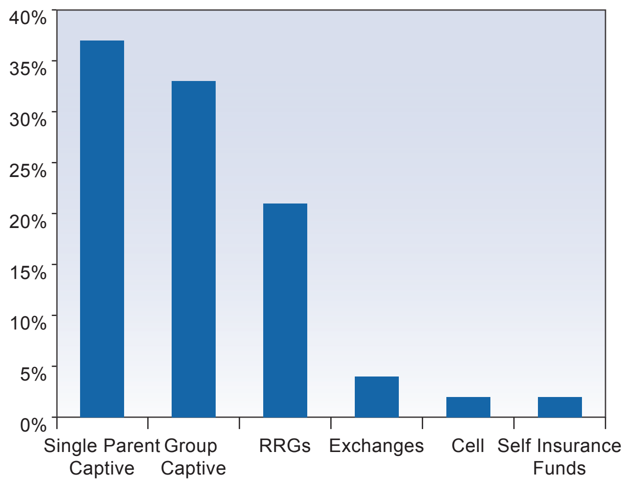
We provide 3,600 ratings on companies of all sizes in more than 90 countries, including nearly 200 alternative risk transfer entities and 300 mutual companies. Headquartered in the United States, the company does business in over 100 countries with regional offices in London, Amsterdam, Dubai, Hong Kong, Singapore and Mexico City.

The Value of an AM Best Credit Rating for Captives

- AM Best is the only Nationally Recognized Statistical Rating Organization (NRSRO) focused solely on insurance.
- We rate single-parent and group captives, risk retention groups (RRGs) and protected cell captives in a number of domiciles.
- We rate new formations, startups and companies of all sizes.
- We provide captive owners/managers with an independent, third-party assessment of balance sheet strength, operating performance, business profile and enterprise risk management.
- Our interactive rating process serves as a roadmap for practicing sound risk management and effective business strategy.
- Our analysis offers valuable insight into a captive's organization, its management, governance and track record.
- A Best's Credit Rating establishes a captive's acceptability and credibility with third parties, including regulators, reinsurers and other counterparties.
- Our rating process addresses single-parent captives as a critical component of its parent's risk management program.
- A Best's Credit Rating may further the ability to attract and retain member insureds.
- We have extensive access to insurance data and market intelligence, covering thousands of companies worldwide through analytical resources and news coverage that provide a critical perspective.

AM Best Global Captive Coverage and Type





Value for the Industry

- Only international rating agency dedicated exclusively 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 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
- Leading position in international reinsurance hubs—including comprehensive coverage of Lloyd's/London market, Bermuda, Zurich and Singapore
- Leading rating agency for (re)insurance in the emerging markets of MENA and South and Central Asia

Market Coverage

- Property/Casualty (Non-life)
- Life and Annuity
- Health
- Reinsurance
- Mutual Insurers
- Startup Reinsurers
- Alternative Risk Transfer (ART) Vehicles—Captives, Pools and Risk Retention Groups
- Protection & Indemnity (P&I) Clubs
- Debt—Corporate Debt, Preferred Stock and Hybrid Securities, Commercial Paper, Insurance-based Liability or Asset-backed Securitizations, Closed-block Monetizations
- Fronting Companies
- Title Insurance
- Surety Companies
- Takaful, Retakaful and Co-operative Insurers
- Lloyd's and its Syndicates

Best's Credit Rating Users

- Insurance Companies
- Agents
- Brokers
- Policyholders
- Financial Institutions
- Investors and Investment Professionals
- Employee Benefits Managers
- Debt and Equity Research Analysts
- Corporate Risk Managers
- Reinsurers
- Captive and Alternative Risk Managers
- CFOs and Boards of Directors
- Consumers
- Government Agencies
- Regulators
- Academics

Best's Credit Rating Scale

Translation of Issuer Credit Ratings to Financial Strength Ratings

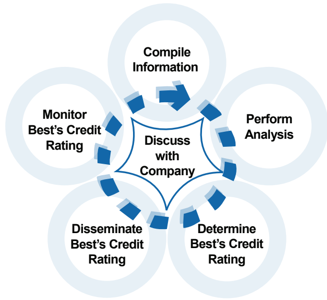
Long-Term ICR	FSR
aaa, aa+	A++
aa, aa-	A+
a+, a	A
a-	A-
bbb+, bbb	B++
bbb-	B+
bb+, bb	B
bb-	B-
b+, b	C++
b-	C+
ccc+, ccc	C
ccc-, cc	C-
c	D

AM Best Credit Rating Definitions

- **Best's Issuer Credit Rating (ICR):** An independent opinion of an entity's ability to meet its ongoing financial obligations, issued on either a long- or short-term basis
- **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 Issue Credit Rating (IR):** An independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation, 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

AM Best assigns three types of Best's Credit Ratings for insurance companies. All are independent opinions based on a comprehensive quantitative and qualitative evaluation of a company's balance sheet strength, operating performance, business profile, enterprise risk management and, where appropriate, the specific nature and details of a rated debt security. They are not a warranty of a company's financial strength and ability to meet its obligations to policyholders or other financial obligations.

Best's Credit Rating (BCR) Process



The typical duration from signed contract to ratings dissemination is generally about three to four months. Each interactively rated entity is assigned to a rating analyst, who manages the ongoing interaction with company management and conducts the fundamental credit analysis as described in AM Best's rating criteria.

Best's Credit Ratings (BCRs) are initially determined and periodically updated through a defined rating committee process. The rating committee itself consists of analytical staff and is chaired by senior rating officers. The committee approach ensures rating consistency across different business segments and maintains the integrity of the rating process (described briefly below).

1 Compile Information
The assigned analyst collects public and proprietary financial information and data to develop a tailored meeting agenda.

2 Perform Analysis
AM Best incorporates a host of qualitative and quantitative measures to evaluate the organization's financial health.

3 Determine Best's Credit Rating
The AM Best Rating Committee ensures rating consistency and maintains the integrity of the rating process and methodology.

4 Disseminate Best's Credit Rating
If the initial Best's Credit Rating is accepted, it is distributed via the AM Best website, press releases, and a number of print and digital publications.

5 Monitor Best's Credit Rating
AM Best regularly monitors the rating by continually analyzing the organization's creditworthiness.

AM Best relies primarily on information provided by the rated entity, although other sources of information may be used in the analysis.

Sample Information Inputs

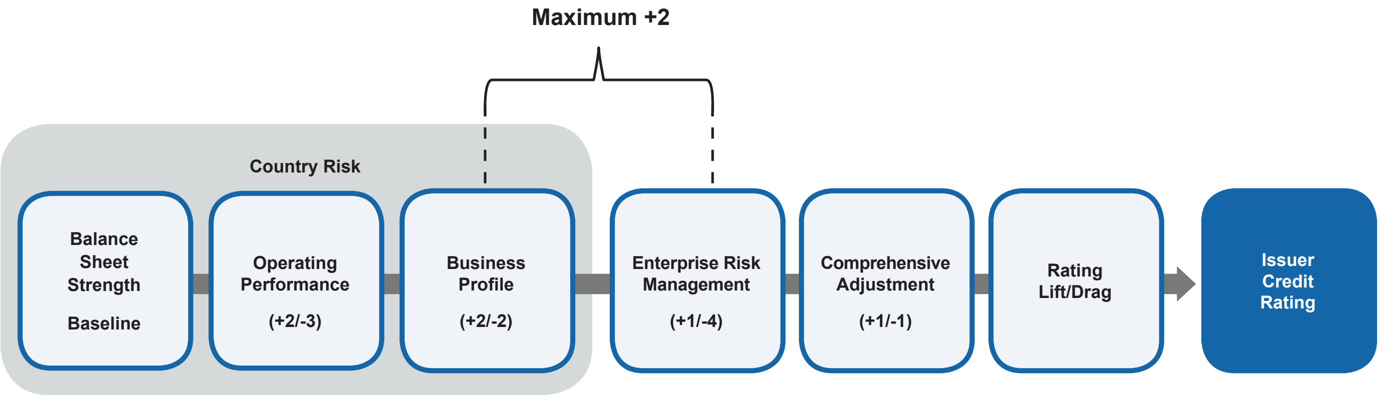
Private		Public
• Capital structure • Investment and credit guidelines • Reinsurance guidelines • Exposure to catastrophes • Enterprise Risk Management (ERM) • Internal capital models	• Meeting with key executives • Business plans and projections • Supplemental Rating Questionnaire (SRQ) • Actuarial memorandum • Loss provision reports • Cash-flow stress testing	• Financial statements • Reports to shareholders • Public records • Regulatory reports and disclosure notes • Audit reports • Compliance and ethical conduct reports

For more information on Best's Credit Rating process, please visit http://www.ambest.com/ratings/index.html.

Overview of Best's Credit Rating Methodology (BCRM)

This overview provides a quick look at the components of Best's Credit Rating Methodology (BCRM) and rating process. For more information related to the complete BCRM, including various comprehensive criteria procedures applicable to aspects of the insurance and reinsurance industry globally, please visit the Best's Credit Rating Methodology section of our website at www3.ambest.com/ambv/ratingmethodology/.

Best's Credit Rating Methodology (BCRM) provides a comprehensive explanation of AM Best's rating process. Key rating factors—including an insurer's balance sheet strength, operating performance, business profile and enterprise risk management (ERM)—are qualitatively and quantitatively evaluated during the rating process. The foundational building blocks of AM Best's rating approach are outlined below.



AM Best's Rating Process

Balance Sheet Strength

AM Best's rating analysis is an interactive process that begins with an evaluation of the company's balance sheet strength. This evaluation includes a three-part analysis focusing on the following areas:

1. The insurance rating unit (the insurer)
2. The financial flexibility and risks associated with the insurer's holding company and/or ownership structure
3. The impact of country risk on the insurer's balance sheet strength

Baseline Balance Sheet Strength Assessment

The assessments of the insurance company and its holding company result in the company's "Combined Balance Sheet Strength Assessment." AM Best arrives at a company's baseline balance sheet strength assessment by incorporating country risk. The baseline is selected for the company from the various options in the Overall Balance Sheet Assessment chart and is determined through analytical judgment and rating committee review.

Balance Sheet Strength Assessment Factors	
• BCAR	• Adequacy of reserves
• Quality and appropriateness of reinsurance programs	• Liquidity
• Quality and diversification of assets	• Quality of capital
• Financial and operating leverage	• Internal economic capital models

Best's Capital Adequacy Ratio (BCAR)

The measurement of the insurer's capital adequacy is key to the balance sheet assessment. AM Best uses its Best's Capital Adequacy Ratio (BCAR) to differentiate an insurer's balance sheet strength and determine whether its capitalization is appropriate for its risk profile. The BCAR evaluates many of the insurer's balance sheet risks simultaneously, generates an estimate of the capital needed to support those risks at different confidence intervals and compares it with the insurer's available capital.

BCAR Assessment

VaR Confidence Level (%)	BCAR	BCAR Assessment
99.6	> 25 at 99.6	Strongest
99.6	> 10 at 99.6 & ≤ 25 at 99.6	Very Strong
99.5	> 0 at 99.5 & ≤ 10 at 99.6	Strong
99	> 0 at 99 & ≤ 0 at 99.5	Adequate
95	> 0 at 95 & ≤ 0 at 99	Weak
95	≤ 0 at 95	Very Weak

Country Risk

Country risk and its assessment are incorporated into the analysis of balance sheet strength, operating performance, and business profile. AM Best defines country risk as the risk that country-specific factors will adversely affect an insurer's ability to meet its financial obligations.

Overall Balance Sheet Strength Assessment

Combined Balance Sheet Assessment (Rating Unit/Holding Company)	Country Risk Tier				
	CRT-1	CRT-2	CRT-3	CRT-4	CRT-5
Strongest	a+/a	a+/a	a/a-	a-/bbb+	bbb+/bbb
Very Strong	a/a-	a/a-	a-/bbb+	bbb+/bbb	bbb/bbb-
Strong	a-/bbb+	a-/bbb+	bbb+/bbb/bbb-	bbb/bbb-/bb+	bbb-/bb+/bb
Adequate	bbb+/bbb/bbb-	bbb+/bbb/bbb-	bbb-/bb+/bb	bb+/bb/bb-	bb/bb-/b+
Weak	bb+/bb/bb-	bb+/bb/bb-	bb-/b+/b	b+/b/b-	b/b-/ccc+
Very Weak	b+ and below	b+ and below	b- and below	ccc+ and below	ccc and below

Operating Performance

The second building block of AM Best's rating process is operating performance. This analysis can result in an increase, decrease, or no change to the baseline assessment. Possible adjustments range from +2 notches to -3 notches.

AM Best views operating performance as a leading indicator of future balance sheet strength and long-term financial stability. A company's profitability affects its ability to generate earnings, and profitable insurance operations are essential for a company to operate as a going concern. In general, more diversity in earnings streams leads to greater stability in operating performance. AM Best's analysis of operating performance focuses on the stability, diversity and sustainability of the company's earnings sources and the interplay between earnings and liabilities.

Business Profile

Business profile is the third building block in AM Best's rating process and is a highly qualitative component of AM Best's rating evaluation. Business profile may ultimately affect an insurer's current and future operating performance and, in turn, its long-term financial strength and ability to meet its obligations to policyholders. Possible adjustments for business profile range from +2 notches to -2 notches.

The business profile review includes evaluation of the following factors:

- Market position
- Degree of competition
- Distribution channels
- Pricing sophistication and data quality
- Management quality
- Product and geographic concentration
- Product risk
- Regulatory, event, market and country risks

Enterprise Risk Management (ERM)

ERM is the fourth building block in the rating process. The impact of ERM on an insurer's rating is based on understanding the development and implementation of an insurer's risk management framework as well as the insurer's risk management capability relative to its risk profile. The framework and the risk evaluations include the following sub-assessments:

Framework Evaluation	Risk Evaluation
• Risk identification and reporting • Risk appetite and tolerance • Stress testing and non-modelled risks • Risk management and controls • Governance and risk culture	• Product and underwriting • Reserving • Concentration • Reinsurance • Liquidity and capital management • Investments • Legislative, regulatory, judicial and economic • Operational

If a rating unit is practicing sound risk management and executing its strategy effectively, the results will be evident in successful performance over the long term. Possible adjustments for ERM range from +1 notch to -4 notches.

Companies with complex global business profiles have a need for a robust and comprehensive ERM program. In many cases, the complexities and demands of these companies' "Very Favorable" business profiles require an equally "Very Strong" ERM. Acknowledging this interaction, and the limited impact that these two highly qualitative building blocks may have on credit strength, the combined impact between business profile and ERM will be restricted to a maximum of +2 notches. This calculation would only affect those companies that have both a "Very Favorable" business profile assessment and a "Very Strong" ERM assessment.

Comprehensive Adjustment

A comprehensive adjustment may be applied in the rating process when the company being reviewed has an uncommon strength or weakness that exceeds (or is less than) what has been captured through the rating process up to this point. A comprehensive adjustment can increase or decrease the assessment by a maximum of 1 notch. The vast majority of ratings will not require a comprehensive adjustment.

Rating Lift/Drag

In this step, the company may be afforded lift (or drag) based on factors such as integration, strategic importance and contribution to the overall enterprise. The amount of lift or drag assigned depends on the specific circumstances of the insurer. For further details, please visit http://www3.ambest.com/ambv/ratingmethodology/.

Published: October 13, 2017

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The following criteria procedure should be read in conjunction with *Best's Credit Rating Methodology (BCRM)* and all other related BCRM-associated criteria procedures. The BCRM provides a comprehensive explanation of AM Best's rating process.

Market Overview

AM Best categorizes Alternative Risk Transfer (ART) vehicles into the following broad groupings: single-parent (and pure) captives, group captives, risk retention groups, self-insurance funds, and protected cell companies. Their unique characteristics are discussed in the following sections.

Types of Captives

Single-Parent and Pure Captives

Single-parent captives are owned by one company or group (the parent). Pure captives are single-parent captives that accept only the risks of the owner (or owner-affiliates). Not all single-parent captives are pure captives; in some instances, a single-parent captive can accept business from third parties.

Group Captives

Group captives 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 have similar rating dynamics.

Risk Retention Groups (RRGs)

In the US, risk retention groups (RRGs) are governed under the Liability Risk Retention Act (LRRA) and designed to provide liability insurance for a consortium with similar business interests. Under this federal statute, an RRG is (except as specifically designated by LRRA) subject only to the regulatory authority of its domicile state, even if it is a multistate insurer. This has implications for the rating process when considering the treatment of substitute forms of capital, particularly qualifying letters of credit (LOCs) and New York Regulation 114 trusts.

Self-Insurance Funds

Several US jurisdictions allow for self-insurance funds as an alternative form of insurance. By definition, these types of ART instruments can write selected coverages only for policyholder owners doing business in that particular area. These funds differ from commercial insurers primarily in two ways: They are subject to (1) joint and several liability for any claims and (2) governed under a specific charter whereby the surplus is composed wholly of subscribers' savings accounts. "Joint and several liability" stipulates that all of the subscribers' savings accounts and all of the policyholder owners' assets can be used to satisfy any claims.

Protected Cell Companies (PCCs)

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

For the purposes of this criteria procedure, and in line with most jurisdictions, a PCC is the legal entity comprised of a core and one or more incorporated and unincorporated cells which have assets and liabilities separate and apart from the assets and liabilities of other cells.

Evaluating a PCC requires a clear understanding of the characteristics of the business in the PCC, and of the PCC's structure, domicile, and ability to manage the exposures of its sponsor.

An insured organization that establishes its own PCC and divides its risks into a number of protected cells (PCs) within the PCC will essentially be treated like a pure captive insurer for rating purposes.

In contrast, in the case of a PCC composed of an amalgamation or hybrid of unaffiliated protected cells, whose assets and liabilities are segregated and whose owners or co-owners are unaffiliated with the owner(s) of the PCC, each protected cell will be reviewed independently to ensure that the risks transferred to each cell are being managed and funded at the levels commensurate with the PCC. Although each cell is evaluated individually, this analysis is conducted in conjunction with the analysis of the PCC. It is from the analysis of each protected cell that the concept of the weakest link is applied. This concept stems from AM Best's view that all of the PCC's policyholder rights are to be deemed pari passu with each other. While the pari passu concept applies, it is important to note that AM Best's ratings only apply to the PCC. AM Best does not assign separate ratings to any individual cell.

Protected cell companies are unique and have been in existence for more than two decades and AM Best fully appreciates the nuances of the PCC business model, the economies of these structures, the purpose of segregated funds and the basis for establishing and forming protected cells. Segregated cells have various legal structures, ranging from incorporated cells that have their own articles of incorporation and enter into contracts with other entities (including other incorporated cells) on theirown paper, to protected cells that are not independently licensed and accept risk through internal financial transactions with the core cell. At present, AM Best only assigns its ratings to the PCC.

The Rating Process

There are some key differences in the way that ART vehicles operate that affect the rating process and the building block assessments (outlined in Exhibit A.1). These considerations are discussed in the following sections, as are any instances in which the availability of the BCRM assessment descriptors (Exhibit A.2) differs from the process outlined in the BCRM.

Exhibit A.1: AM Best's Rating Process

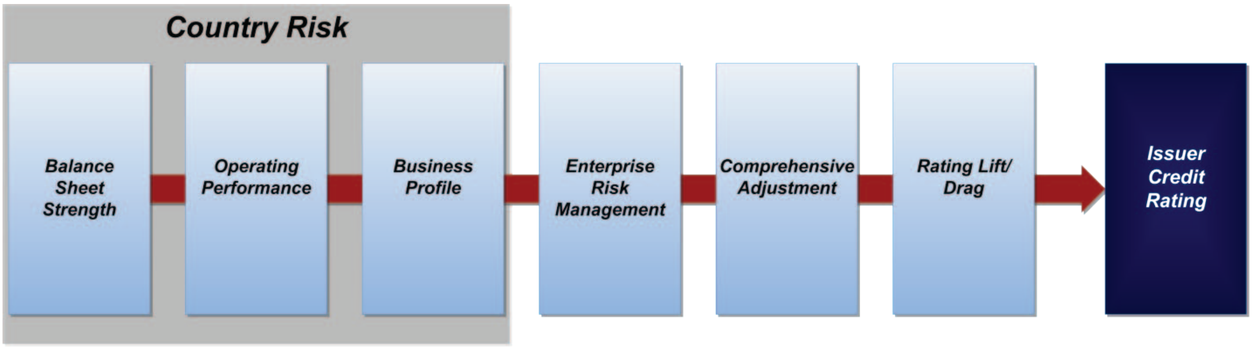

Exhibit A.2: BCRM Assessment Descriptors

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

B Balance Sheet Strength

Treatment of Letters of Credit

Letters of credit 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). LOCs can be used to capitalize an ART entity, an arrangement encouraged by a number of captive insurance regulators, to help access an ART entity's capital if needed. As a result, an LOC may have more equity- like characteristics, which could result in equity credit for Best's Capital Adequacy

Ratio (BCAR) purposes depending on the details of the LOC arrangements. LOCs eligible for consideration, will adhere to most, if not all, of the following:

- Standalone
- Irrevocable
- Evergreen
- Funded
- Drawn on a highly rated bank

"Standalone" means that the instrument is not part of a credit facility or agreement that may contain covenants and terms that can impair the LOC's liquidity. "Evergreen" and "irrevocable" mean that the instrument automatically renews and cannot be canceled except by prior written agreement by all parties. "Drawn on a highly rated bank," means that the LOC is to be funded with assets on deposit in a highly rated bank. This ensures that the bank takes the risk if the assets fall short of the face amount and that the credit risk of the bank does not cause an undue haircut of equity credit.

The LOCs that possess these elements may receive up to 100% capital credit, which may not be subject to the usual threshold of 20% of total available capital. Qualifying New York Regulation 114 trusts under similar conditions can receive capital credit as well.

Net Retention to Surplus
An ART entity's balance sheet strength assessment can be adversely affected if the company writes a net aggregate per-occurrence limit greater than 10% of total available capital. This typically occurs when an ART entity provides large limits protection on high value properties or indemnity protection on high excess liability exposures. Such exposures may or may not be modelled. AM Best may use information it deems relevant to estimate potential large losses, such as the entity's full retained loss limit at all of the confidence levels in the BCAR model or by using some other metric (such as a probable maximum loss) which is viewed to be more appropriate when considering the particular risk(s) involved and the assumptions and data supporting the assessment.

Loan-Backs to the Parent Company
Captives may want to make a loan of working capital to the parent organization for a number of reasons. In order to give these loans consideration in the rating analysis, AM Best expects that domicile-approved "loan-backs" will be documented properly with an arms-length loan agreement. The loan-back is then charged a risk factor that takes into account the risks associated with the loan, which may include a single large investment charge. The largest risk is generally the parent company's credit risk, which is assessed via external credit ratings (when available) and internal financial analyses. A loan-back may pose other risks—relating to the strength of the loan-back agreement and the parent company's cash-flow volatility, for example—that may factor into the assessment. The relative aggregate size of the captive's LOCs and loan-backs in relation to its total capital may also affect the assessment.

Holding Company Assessment
A holding company impact review is not part of the balance sheet assessment process for lead rating units with non-insurance parents. Instead, the impact of the non-insurance ultimate parent is captured in the rating lift/drag assessment.

Balance Sheet Strength Considerations for Different Types of ART Vehicles

RRGs
RRGs are distinct from other types of insurers in that only owners can contribute capital to the group, and only policyholders can be owners. Therefore, a managing general agent (MGA) or third-party administrator (TPA) that runs a program using an RRG to write the liability insurance cannot make a capital contribution to the organization; what it can do to bolster capital is sponsor a qualifying LOC. After conducting a detailed analysis of the sponsor's long-range intentions, AM Best may consider giving available capital credit in BCAR in these situations if conditions warrant.

Self-Insurance Funds
AM Best generally gives full credit in BCAR to Subscribers' Savings Accounts, depending on the specifics of the individual self-insurance fund.

PCCs
For those PCCs composed of a group of protected cells unaffiliated with the core PC, the balance sheet strength assessment includes an analysis of each cell's segregated funds on an expected and stress scenario basis, and reviews of each cell's financial flexibility and access to additional funding if needed. Financial flexibility and access to funding can take the form of contractual arrangements with the core PC or the cell owner itself.

AM Best considers the PCC to be only as strong as its weakest cell. Therefore, the onus is on the PCC to ensure that each of its segregated cells is adequately capitalized. Throughout the year, AM Best reviews available financials on rated PCCs and their individual cells. Assuming that the designated individual cells bear all of the risk placed in the PCC, the balance sheet strength analysis will focus on the individual cells and the likelihood of a cell eroding its capital and that of the PCC. The evaluation will examine each cell's financial condition, risk profile, loss and incurred but not reported (IBNR) reserves, and the credit exposures it has accumulated. In addition, any contractual relationships with other protected cells and with the PCC will be reviewed thoroughly. Financial flexibility and the capital adequacy of each cell are critical factors in the analysis.

AM Best reviews any contractual arrangements the PCC maintains with its member cells to determine how much, if any, financial flexibility the arrangements afford. These arrangements could take the form of capital maintenance guarantees, stop-loss agreements, or other similar arrangements with the PCs. The contracts need to be examined carefully to determine the extent of these liabilities, as well as any risk-sharing among the cells.

The link between individual protected cells and the PCC becomes increasingly important if the failure of a segregated cell has the potential to result in disruption for or financial stress to the PCC or to other cells within it. Thus, when establishing a protected cell, a PCC's ability to look to those segregated cells and their sponsors for the necessary support and funding is extremely important. The greatest risk in a PCC structure is not necessarily the risk that each individual protected cell poses to another; rather, it is the link between the segregated cell(s) and the PCC.

Operating Performance

Capital Preservation and Operating Performance

The ART marketplace was born out of the capacity shortages and price volatility of the commercial insurance market that have historically resulted from the vagaries of the underwriting cycle. The mission of an ART vehicle is to provide consistent, tailored coverage at stable pricing to policyholder owners. Thus, these entities typically focus more on preserving capital rather than on generating returns for shareholders. Rated ART entities generally record solid profitability before policyholder and stockholder dividends. As a result, ART vehicles may appear to have lower levels of underwriting and net income available to common shareholders. Consideration is given within the operating performance assessment to return measures before and after dividends, depending on an ART's historical use of these dividends.

Volatility of Operating Results

Because a captive's risk is relatively narrow in scope, there tend to be periods of very low losses contrasted with periods of significant losses. What AM Best looks for in these cases is the parent company's history of demonstrated support or a documented support agreement that outlines the intent and ability to support the captive with economic resources if needed.

Business Profile

In general, an ART entity not receive a business profile assessment higher than "Neutral." However, AM Best does recognize the unique nature of the relationship between the ART entity and the insured, and its impact on business profile. ART vehicles can have customized coverages, customer-specific claims, and loss-control solutions, and owner insureds representatives on their boards.

AM Best typically looks for signs of how well and to what degree the captive is entrenched in the parent's insurance risk management function and the ways in which the captive provides value. In other cases, the commercial activities of the captive might be used simply as a risk-financing tool.

Business Profile Considerations for Different Types of ART Vehicles

Group Captives and RRGs

Insured renewals for group captives and RRGs tend to be much higher than for commercial insurers, averaging more than 90%. Group captives and RRGs gain and retain business by providing narrowly defined and very specific products to address specific needs. Historically, value-added services such as loss control and engineering, in addition to policyholder dividends, have enabled these ART vehicles to hold onto customers even in soft insurance cycles.

PCCs

Based on the variations in the legislative and regulatory provisions and enforcement mechanisms in different domiciles, the regulatory framework under which PCCs are established is a key component in the business profile assessment.

Enterprise Risk Management (ERM)

AM Best will assess the risk management framework and profile/capability of the captive, relative to the parent company's business operations.

ERM Considerations for Different Types of ART Vehicles

Group Captives and RRGs

The ERM assessment for group captives and RRGs is similar to that of a commercial writer, and focuses on the captive's risk management framework and risk profile relative to its capabilities.

PCCs

Control and monitoring of any PCC program are crucial, to ensure that the expectations for response to claim incidents will be met, given the capabilities and limitations of individual cells; measures taken to address these concerns should be evident in the PCC's ERM framework processes.

Other important risk considerations include the type of PC used—whether open or closed to new business, or some variation in between—as well as the contractual relationships among the cells in the program, and between them and the PCC. Fronting and reinsurance agreements are also examined in detail to determine whether the protected cell program will be adversely affected by the provisions in those agreements.

Published: October 13, 2017

Rating New Company Formations

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A. Market Overview

New companies are formed for many different purposes, using a variety of business models. For example, in some cases, a newly formed company is an extension or spin-off of an existing operation, whereby the new company is in effect inheriting an existing block of business. In other cases, the new company is a more traditional start-up venture lacking an operating performance history. This criteria procedure covers all rating units based on new company formations, including start-up ventures not affiliated with a currently rated organization, as well as new companies formed within a currently rated group.

A new company's sponsors and/or strategic investors can significantly affect its success in meeting its objectives. The experience and commitment of a sponsor or investor to the company over the near and long term, including any potential exit strategies, are key considerations in the rating process. AM Best's rating approach for new companies recognizes these distinctions and allows appropriate flexibility in the assessment and evaluation.

Requirements for an Initial Rating Assignment

For AM Best to proceed with an initial rating assignment, certain conditions and factors must be present:

1. A clearly defined five-year business plan that all principals are in accord with and are well qualified and capable to implement, and that includes the following:
    - 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
    - Financial projections, along with the underlying quantitative and qualitative assumptions and the anticipated use of capital
2. Initial financing in place or expected to be paid into the capital of the rated (re)insurance entity concurrently with the initial rating assignment
3. Stress-tested capitalization that conservatively supports the business plan
4. 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
5. Management, board members, strategic investors, investment bankers, actuaries and other advisers available for discussions with AM Best, to provide comprehensive disclosure of requested information
6. A follow-up process to measure the effectiveness of the initial business plan and to monitor the company's strategic and financial development

New Company Rating Process

AM Best's rating process applies the same rigorous criteria to all insurers, new or established, which allows for a direct comparison of insurers regardless of longevity or country of domicile. To rate new company formations, AM Best uses the same assessment building blocks as it does for established companies (Exhibit A.1). This criteria procedure focuses on the areas that receive particular emphasis in the process of rating a new company formation, such as the review and analysis of (1) business plans, (2) the assumptions underlying the new company's projections, and (3) its operational controls. In addition, more stringent quantitative and qualitative metrics may be applied, to reflect the heightened level of uncertainty inherent in reviewing a new company.

Exhibit A.1: AM Best's Rating Process

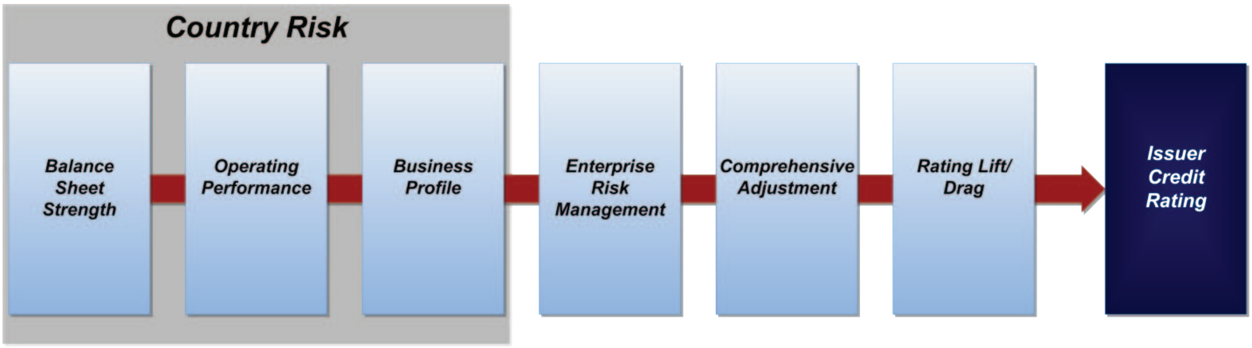

Exhibit A.2: BCRM Assessment Descriptors

Balance Sheet Strength	Operating Performance	Business Profile	Enterprise Risk Management
Strongest	Very Strong	Very Favorable	Very Strong
Very Strong	Strong	Favorable	Appropriate
Strong	Adequate	Neutral	Marginal
Adequate	Marginal	Limited	Weak
Weak	Weak	Very Limited	Very Weak
Very Weak	Very Weak		

Exhibit A.2 details the possible assessments for each building block as described in the BCRM. However, owing to the unique considerations associated with rating a new company, the range of assessments available for it may be more limited than those listed in the exhibit.

Rating Unit Eligibility
Should a new company be added to an established rating unit and given its affiliation code, the rating analysis would follow the assessment process detailed in the BCRM.

B. Balance Sheet Strength

Because of heightened uncertainty about future balance sheet conditions, companies with less than five years' operating experience or limited business plan execution are generally precluded from receiving a balance sheet strength assessment of "Strongest."

Quantitative Analysis
AM Best's assessment of the strength and quality of a company's balance sheet is the foundation of any credit rating. A new company's initial and prospective net required capital levels (and related capital metrics, including financial leverage) typically will need to be more conservative than what is expected of a comparable company that has a history of ongoing operations and that is assigned the same rating. This level of conservatism applies throughout the development phase of the new company formation, even after factoring in conservative expectations for earnings and investment returns. The additional capital requirement reflects the lack of operating history and the operating risk associated with executing a new business plan. The new company should demonstrate that it can (1) effectively execute its business plan throughout the plan period typically, five years and (2) maintain available capital at levels well above what typically would be expected of a more mature company at the assigned confidence level.

The amount of additional capital needed will reflect the business's risk profile. A higher level of capital might be required if the business is subject to low-occurrence but high-severity events, for instance, or operates in a line of business that typically creates an initial drain on capital owing to the slow emergence of profits. AM Best will also assess the pace at which the company expects to use its capital. The capital required will reflect the greater risks inherent in a start-up venture compared with an established company's continuing operations, at all confidence levels.

As of the initial rating date, AM Best expects the new company formation to have on-balance-sheet capital to support the appropriate net required capital adequacy levels, in light of the company's projected business activities. In determining the initial on-balance-sheet capital requirement for a specific new company formation, AM Best will consider the type of business to be written; the expected growth pattern (including whether the plan calls for organic growth or growth through block acquisition); the availability of additional financial support; and the risks related to the capital structure of the new company formation and the parent or investor providing additional financial support. The BCAR calculated for the new company formation and used in 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 span of the business plan (typically a five- year period), such as the increased underwriting risk and volatility of technical results associated with a lack of experience in new markets or new lines of business. Additional capital requirements represent a cushion for companies whose growth exceeds expectations, given that a new company's ability to generate organic capital is often limited in the early stages of development. BCAR-based stress tests on capitalization that conservatively support the targeted confidence levels throughout the operating plan in a number of scenarios will be run, depending on the risk profile of the rating unit. However, as with any credit rating, capitalization and the BCAR results are not the sole determining factors in the assignment of a rating.

Other Qualitative Factors

AM 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. For new company formations, the balance sheet strength evaluation places particular emphasis on the following:

- The initial amount of on-balance-sheet capital, other committed capital, and additional financing resources
- The quality of capital, including the use of reinsurance, credit facilities, and other forms of contingent capital financing
- Investor expectations for dividends
- The capital generation anticipated from core business activities
- Expected reserving levels (conservative or aggressive)
- An investment strategy for reserves and capital for both the short and long terms. 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, AM Best will review the quality and diversification of assets and the reputation and experience of the investment managers.

Holding Company

For new companies, the impact of a newly formed holding company is unlikely to be positive, given the lack of demonstrated financial flexibility. For established holding companies, the analysis follows the process outlined in the BCRM.

C. Operating Performance

AM Best views operating performance as a leading indicator of future balance sheet strength and long-term financial stability. Operational controls encompass the stringent set of qualitative analysis and standards used to assess operating performance, given the lack of a history of operating performance inherent in a new company formation. When assessing operating performance, analysts will review:

- Management's demonstration of a successful operating performance relevant to the new venture's core business
- Investor expectations of earnings
- Return expectations vs. market realities
- Projected financial results, including balance sheet, income statement, cash flows, and capital obligations
- Pricing targets and financial plans that are compatible with expected returns and capital generation and protection

Given the lack of track record for true start-ups (greenfield operations), a newly formed company is unlikely to receive an assessment higher than "Adequate" for operating performance, and may be assigned a lower assessment owing to its start-up nature and the expected volatility of the business written. Operating performance is often strained at the outset by pressure from high fixed costs, potentially resulting in operating losses. The ability to build a supportive base of business is frequently a challenge. The performance of acquired blocks of business with operating track records may be viewed either positively or negatively in the assessment.

D. Business Profile

Business Plan and Strategy
A clearly defined business plan is essential. A company's success depends on management's ability to effectively implement the business plan while remaining responsive to changing conditions. Experience with organizing new insurance ventures also is factored into the process. The business plan and financial targets serve as benchmarks against which AM Best will measure a company's success in the first few years. Areas AM Best explores include the following:

- 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
- Whether the new company is set up with a sustainable, long-term business plan or whether its creation is driven by other factors, such as compulsory business or a tax-driven strategy

Key information typically reviewed in AM Best's evaluation includes the following:

- A well-defined five-year business plan
- Targeted classes of business
- Regulatory considerations
- Competitive environment and the characteristics that will differentiate the company
- Distribution/client relationships
- Pricing methodologies and monitoring practices

Given the lack of brand awareness, a newly formed company is unlikely to receive an assessment higher than "Neutral" for its business profile, and may be viewed even more negatively until it has gained market acceptance. Companies that are part of larger, well-recognized groups may receive some benefit in the business profile assessment.

Typical observations of the sub-assessments within business profile follow.

Market Position
Market position is not meaningful in the initial year or so of operation, as a new company's market share may be close to or equal to zero at the time of the rating assignment. As the company executes its business plan, its market share may increase to meaningful levels for evaluation. However, rapid increases in market share are likely to be viewed as "Negative."

Likely Assessment: Neutral to Negative

Degree of Competition
The analyst will review the barriers to entry for the market(s) that the new company is looking to enter. True start-ups are likely to be viewed as "Negative" in this category, because they tend to underestimate the level of competition, unless it is a new market opportunity with very few established competitors.

Likely Assessment: Neutral to Negative

Distribution Channels
Initially, a new company's distribution channels will have a limited impact on the evaluation. The importance of distributions channels will increase over the life of the business plan, and the analyst will evaluate whether distribution is productive, produces high quality business, and is persistent. Concentration in distribution channels can have a negative impact on the assessment.

Likely Assessment: Neutral to Negative

Pricing Sophistication and Data Quality
New companies may have access to more sophisticated technology and be unburdened by less robust legacy systems. In this case, a "Positive" view may be possible for this component. A "Negative" view could also be possible depending on the company's data quality and whether it uses third-party data for pricing.

Likely Assessment: Positive to Negative

Management Quality
The experience and depth of management are important determinants in the ultimate success of a new operation. A strong record of success both with start-ups and in the chosen line(s) of business could result in a "Positive" view for this component; however, the evaluation should account for the difficulties associated with blending multiple management styles.

Likely Assessment: Positive to Negative

Product/Geographic Concentration
The evaluation will take into account the plan and scope of the new company's operations. Similarly to existing companies, single country/state or limited geographic/product focus is likely to result in a "Negative" view for this component.

Likely Assessment: Neutral to Negative

Product Risk
The risk associated with each of the individual products the new company offers can also have a strong impact on business profile.

Likely Assessment: Positive to Negative

Regulatory, Event, Market, and Country Risks
The analyst will evaluate any unique regulatory, event, market, or country risk hurdles the new company may face.

Likely Assessment: Neutral to Negative

E. Enterprise Risk Management (ERM)

Management
AM Best looks at the depth of 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. Extensive conversations with, and an assessment of, management are central to this process for any new company rating. An assessment of management entails developing an understanding of the organization's risk management framework and financial management expertise. Given the limited period of development, the ERM assessment is likely to fall between "Appropriate" and "Weak." AM Best's evaluation of risk management takes into account execution risk, including the failure to build out operational capabilities on a timely basis; failure of key underwriting controls resulting in losses; and failure to retain key employees.

AM Best's review of enterprise risk management considers:

- Experience managing other operations through start-up and changing business conditions
- Financial and operational risk tolerance
- Defined risk management and underwriting policy statements
- The consistency of the business plan and investment strategy, whether they are in line with those of sponsors or investors and with market realities
- Alignment of incentive compensation plans, employment contracts, and management investments with the company's long-term financial and strategic goals, shareholder value, and policyholder security
- Management's ability 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
- Expertise and processes with regard to managing assets, liabilities, and other drivers of enterprise risk individually, as well as the interrelationships among risks

Operational Controls
Operational controls are important indicators of management's ability and commitment to the quality and longevity of a new company, and should be linked to the monitoring and fulfillment of the business plan. Operational controls also are the means by which a new company manages its growth and constitute a large part of enterprise risk management. In its review of operational controls, AM Best considers the following:

- 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
- The company's monitoring of catastrophic exposures and the modeling techniques used
- The company's process for monitoring pricing and underwriting decisions, as well as the frequency and depth of the review process

- The company's monitoring and reporting of investment risk exposures (including fluctuations in interest rates, equity markets, inflation and exchange rates) generated by both its asset holdings and its liability structure, as well as the exposure created by the interrelationship between those risks
- The controls to monitor the new company's distribution relationships, due diligence, productivity, revenue tracking, and expenses

F. Rating Lift/Drag

AM Best considers the competitive advantages that a lead rating unit or non-insurance parent (if the new company is the lead rating unit), might provide to a new company, as well as how the new company is expected to benefit the core business, an indication of the long-term commitment to the new company. Also important is understanding the return investors expect and the reasonableness of those expectations relative to the new company's business plan and existing market conditions. For example, with regard to rating lift/drag, AM Best might favorably view a rated organization that provides turnkey capability to a new company that, in turn, supports its core business. Any inherent risks associated with a start-up company may be somewhat mitigated if the company is a part of a recognized insurance brand with deep operational resources. The start-up may also be able to access the organization's existing client base, investment expertise, risk management, and control systems. Any financial guarantees or reinsurance support that AM Best considers acceptable could factor favorably into the assessment of rating lift/drag.

A more conservative rating approach is required when investors are looking to make a quick return because of favorable market conditions, given that short-term adversity could lead to the withdrawal of 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. The expected dividend policy is a key part of the initial rating analysis, and any subsequent increase in the scale or early introduction of dividends versus the initial plan will be a negative factor in the rating.

The strength of the relationship is evaluated by considering a variety of factors, such as the following:

- The link or synergies with an existing insurance or noninsurance organization, such as a mutually beneficial long-term relationship with the sponsor
- Strategic/operational support
- Additional financial support (i.e., capital contributions, financial guarantees and reinsurance agreements)

September 17, 2020

Aon Bermuda Director: Captives Expanding in Hardening Market

The following is an edited transcript of the interview.

Captives are being tapped to write more traditional insurance, as well as new covers, said Anup Seth, managing director, Aon Bermuda.

Q: How has the current pandemic and economic turmoil impacted captives?
A: Before we talk specifically about the captive market, it's probably worth stepping back and looking at how the broader industry has been impacted by the pandemic. What we're seeing is a consistent theme across our clients, whether they're large corporates, whether they're reinsurance companies, or whether they're insurance-linked securities funds.

That common theme is access to capital. Different companies have taken different approaches to access that capital. What we're seeing on the captive side is certainly our large corporates are accessing their captives for greater utilization, even for liquidity needs.

That overall access to capital, they're seeking that through their captives and positioning their captives as the underwriter of choice as the market continues to harden and access to capital is becoming more and more difficult.

Q: What are you seeing there in the Bermuda captive market?
A: We are definitely seeing an increase in utilization of captives in Bermuda, whether that's increase in retentions, increases in limits that the captive is putting out on existing lines, or even brand new lines of business that the captive is now writing.

We've been very busy making sure that our captives are writing and responding to the corporates' needs at the moment. If that is a material change in the business plan, making sure that we're getting those into the BMA and making sure that the captive is ready to write those additional lines of business.

The second thing we're seeing is an increase in captive formations, both offshore and onshore. We actually have, at Aon, a separate team that conducts feasibility studies. They have been extremely busy during the pandemic.

Q: Could you tell us what the reinsurance market looks like for captives? What does the fronting market look like?
A: Sure. The reinsurance market is also hardening. Prior to the pandemic, we had seen what we would refer to as the W impact or the W effect of a hardening market. What I mean by that is on the front end, the direct market or the primary market had certainly hardened. At the other end of the spectrum, the retro market had also hardened extremely significantly.

The reinsurance market was stuck in the middle where rates had firmed but not as much as the primary market or the retro market. After the impact of COVID-19, and certainly the uncertainty that COVID-19 has brought, we're beginning to see an increase in the hardening of reinsurance rates, as well.

Therefore, the reinsurance market for captives now is much harder. However, we're still seeing an increase in access to reinsurance, whether it's through captives or whether it's through a cell company.

Aon has its own cell company called White Rock. We're certainly seeing an increase in demand for access to reinsurance via White Rock, as well as via captives.

Coming to the other part of your question, the fronting market. The fronting market is certainly getting tougher. Conditions have hardened. Rates have hardened. Captives are having to put up either additional collateral or deal with restrictive terms and conditions imposed by the fronting market.

We have seen tougher negotiations between corporates and the fronting carriers. Again, the captive has a very important role to play as the market begins to harden.

We have actually seen companies utilize their captives, again, for greater access to reinsurance markets, for greater retention. I think the theme we keep coming back to is corporates using their captives now as that strategic risk financing tool and positioning it as the underwriter of choice.

Q: You mentioned new business going into captives. Are you seeing any captive expand to write pandemic-related coverages, either business interruption or other policies?
A: We have seen a couple of pandemic solutions, mainly on a parametric trigger, being developed. We are seeing captives being used, again, to access that capacity, which is in the reinsurance markets or the capital markets.

The lines that we are seeing going into the captives now, the traditional lines are definitely being increased, whether it's property, casualty, worker's comp. Some of the newer lines, certainly D&O as the D&O market has hardened significantly.

We're seeing some of that corporate reimbursement and entity coverage — that's side B and side C cover — certainly being placed in the captive. There's a bit of a circular argument about whether side A should be part of your captive cover, but certainly side B and side C cover, we're seeing that coming into the captives.

Some of those specialty risks, the marine covers, the energy covers. We're seeing more of that now coming into captives, as well.

On the other side, employee benefits. We've seen an uptick in employee benefits cover coming into captives, as well.

Q: You mentioned the parametric pandemic coverage. I tend to think of parametric as related to natural catastrophes. How is that being used, how would it be triggered by a pandemic?
A: It's a very good question. There are several triggers that we've seen work for a pandemic type cover. One would be whether the World Health Organization classifies a particular virus as a pandemic. That's a new one, one trigger.

There are also triggers around specific definitions around number of countries that have to be impacted, number of deaths within those countries, as well, is perhaps another trigger. Sometimes we're seeing dual triggers. You have to have both the WHO classify a virus as a global pandemic and a certain number of deaths in certain countries before the policy would trigger.

Those are some of the examples that we are seeing in the parametric solution.

Q: How do you see the Bermuda captive market evolving in the next year?
A: I would say that as we have moved six months now past the pandemic, or we're living the pandemic now, we're beginning to see how the economic impact is unfolding. …Initially we thought, will this be a V-shaped recovery. Some people said, well, it might even be an L-shaped recovery.

I think what we've actually seen is more of a K-shaped recovery. After the initial fall in March, we've seen certain sectors like technology, like health care, like life sciences [that] have really responded and have emerged even stronger, whereas other industry sectors like travel, like hospitality, have suffered what I would call a second bout.

Hence, we're seeing this K-shaped recovery. I think the way the Bermuda captive … not just the captive market, but the way the Bermuda market will respond to that is around this access to capital.

Corporates that really need that access to capital will continue to utilize their captives in a bigger way. I think we will see that those sectors that are not doing so well will continue to utilize their captives in a more significant way. They will continue to buy more protection from the reinsurance markets, from the insurance markets here in Bermuda.

Because interest rates are so low, we're beginning to see another wave of capital coming into our industry. I think we're seeing this as another inflection point where we've had four or five years of very poor underwriting performance coupled with the impact of the pandemic that has resulted in this inflection point.

We will see, perhaps, a class of 2020 forming in Bermuda. Capital is coming into our industry now, again. Bermuda has a really important role to play to facilitate the deployment of that capital in a very efficient way, whether it's through additional utilization of captives, whether it's through new formations of reinsurance companies, or whether it's a new emergence of ILS funds.

I think Bermuda, or even the life industry. We shouldn't forget about the life industry, how that has developed in Bermuda and continues to go from strength to strength.

When you look at the Bermuda market in its holistic form, all aspects of the market have a real opportunity to perform and ultimately to respond to that client need in this increasing world of risk.

Bermuda, as the world capital of risk, is really well-positioned to benefit from the increased risk that we now face. We're seeing that across all aspects of the Bermuda market.

View the video version of this interview at: http://www.ambest.com/v.asp?v=seth920.

(By: Meg Green: Meg.Green@ambest.com)

September 15, 2020

Hard Market Drives Growth in Bermuda Captive Sector

The Bermuda captive market is poised for growth, both from new captives forming and existing captives expanding as the property/casualty market continues to harden, according to a recent AM Best TV industry panel.

"Bermuda will continue to do well and prosper," said Susan Molineux, director, AM Best. She said captives typically flourish during hard markets, and the market had already begun to tighten before the COVID-19 pandemic hit, causing economic turmoil worldwide. With property/casualty rates rising, terms and conditions tightening, and capacity shrinking, companies are looking for alternative ways to insure their businesses, she said.

Séadna Kirwan, risk advisory director, commercial risk solutions, Aon, said a number of Aon's clients faced challenging Jan. 1 renewals. "They turned to their captives, not just for capacity, but as a means to structure some of their larger property programs," he said.

In addition to property risks, casualty lines, especially professional lines, have been under stress, Kirwan said.

"Companies that have an existing captive are looking to use it in areas where the traditional market is getting very difficult and expensive, and in some cases, the coverage is just not available," Kirwan said. Also more companies are looking to form captives, he said. "We're seeing a significant uptick in new formations."

Another growth area is cell captives.

"We are seeing a huge interest in cell formations," said Michael Parrish, senior vice president, Marsh Captive Solutions. "We've actually taken advantage of Bermuda's new incorporated segregated account legislation and formed a ISAC (incorporated segregated account captive.)

"We're seeing a lot of companies coming to us in fairly distressed state, fairly late in the day, and without the necessary time and probably resources to set up their own vehicles," Parrish said. "The cell options are going to continue to grow, we've seen a lot of interest."

The cell structure allows the policyholders to tap into additional markets, Kirwan said, and it is faster than setting up their own captive. A traditional captive can take three to six months to start, while a company can be up and running in a cell captive in two to four weeks, he said.

Perhaps one surprising casualty line going into captives in Bermuda is Side A directors and officers coverage.

D&O cover is typically split into three covers: Side A covers the director and officers; Side B reimburses the corporation for that cover; and Side C is entity coverage. For a publicly traded company, Side C covers securities claims. Privately held and not-for-profit companies can be covered under Side C for additional risks.

"Traditionally, companies have looked at using captives for Side B and Side C D&O. They've been very reluctant, and in some cases, they're not allowed to use a captive — which is a subsidiary — for Side A cover," Parrish said.

But in the past year, due to the difficulty in buying D&O cover at all, some companies are looking to place Side A directors and officers coverage in a cell captive, he said.

"It's a new use for captives, cell-captives in particular, because it'd be very difficult to do that in a wholly owned captive structure," Parrish said.

While captive laws vary from domicile to domicile, Molineux said this practice wouldn't likely be allowed in the United States "because of the circularity of the coverage and payments."

Directors and officers "wouldn't be too keen on accepting a policy that's been issued by a subsidiary," Parrish said. "If you think about the case of a liquidation or insolvency, the assets of the subsidiary could well be attached as part of the credit settlement, which means that when they came to settling their D&O policy, there would be no money left."

But in a case where a company is struggling to find coverage at any price, a cell captive is an option because its owned by a third party and doesn't have the circularity issue, Parrish said.

Fronting coverage can also be a challenge for captives given the market, the panelists said.

Some carriers are exiting the fronting market, or are taking a harder look at collateral requirements for captives, Kirwan said, while Parrish noted there are fewer insurers able to take on a large global placement in part due to consolidation in the industry.

Captives have traditionally been known for their creativity, and during a time when many companies were surprised to find their traditional business interruption policies lacked pandemic coverage, some captives have had policies in place since the SARS crisis, Parrish said.

"It was a worthwhile thing to do and is an example of how a captive can help in an absolute time of crisis," Parrish said.

On the other hand, Kirwan said one of their clients took the opposite approach, and reinforced their policy to exclude pandemics following SARS. "In this environment where policies are being challenged, they've got a really strong case that the pandemic is specifically excluded," he said.

To view the panel, visit: http://www.ambest.com/v.asp?v=ambcaptives920.

(By: Meg Green: Meg.Green@ambest.com)

August 17, 2020

Marsh's Charnley: PRIA May Offer Captives a Path to Pandemic Coverage

The following is an edited transcript of the interview.

Ellen Charnley, president, Marsh Captive Solutions, said the proposed federal Pandemic Risk Insurance Act would help provide a backstop to all licensed insurers, including captives.

A global pandemic is changing how captive managers are looking at their captives and how companies may be considering the formation of a captive.

I'm speaking today to Ellen Charnley. Ellen is president of Marsh Captive Solutions.

Q: You've been on record as saying that you support the Pandemic Risk Insurance Act. Can you start by explaining the details of that proposed legislation, Ellen?
A: Sure. Marsh, as the company, is a big proponent. I, myself and the captive industry is, too.

The current proposed legislation, which is unfortunately just still proposed. It does have quite a long way to go yet before it would be an act in existence, but it works a little bit like the terrorism act right now, TRIA.

Insurance companies would offer coverage to cover the pandemic and a large proportion of that would be covered by the federal government behind the insurance companies. It's sort of a public/private partnership, if you will.

The advantage for the captive industry is that captives are licensed insurance vehicles, and therefore a captive could offer pandemic insurance and then recover a large proportion on a quota share basis from the federal government backstop under PRIA, in theory.

Q: How do you see PRIA as benefiting captives?
A: I think, as an industry as a whole, it could cause many smaller organizations to consider forming captives that haven't previously formed captives to allow them a mechanism to get significant insurance for the pandemic that, perhaps, would be costly to do on the commercial market.

I think it's going to hit that sweet spot of companies that, perhaps, are currently thinking they're too small to go ahead with a captive but also don't want to pay high commercial rates for pandemic insurance, which it still could be quite expensive.

I think for the captive owners it's going to be advantageous. We are thinking, if it indeed passes in its current form and is like TRIA, there could be quite a significant number of new captives that form.

Q: Is it a given, however, that captives would have access to PRIA?
A: No, it's not a given. We would be very strongly opposed if they're not included. Right now, they're in the draft. It is included. Captives are included. Again, with TRIA they're included.

We would encourage all interested parties, and captive owners, and captive associations to continue to share their support with the government and their local government to ensure that it stays in and doesn't get taken out.

Q: Are you seeing an increase in the number of captive formations, or at least an interest in formation, as a result of the pandemic?
A: I think not necessarily directly to the pandemic itself, but what's happening is the market is hardening. Not only in the US, but across the globe. In the UK, in Asia, for example. Certain areas and certain lines of business are hardening faster than others. For example, D&O insurance rates in the commercial market are extremely high now and escalating.

We're seeing that the hardening market is causing a tremendous amount of activity, which in part is due to the pandemic, but also other factors, as well. The amount of activity and the number of formations in certain parts of the world are definitely higher than they've been in previous years.

Q: Ellen, has consolidation among brokers had any impact on captives?
A: Not really, in terms of the captive growth. It's a question I get often asked about. Is the lack of choice around the number of captive managers around an issue? I haven't seen that as being an issue. I think that there are plenty of companies out there looking for captives and plenty of service providers offering great expertise so I don't think so.

Q: Ellen, what do you say to people who might suggest that captives don't offer enough diversity in their coverages?
A: I'm not even sure I even understand why somebody would ask that question. Captives can write pretty much anything that they want. When I'm asked by a client, "Can a captive write this?" or, "Can a captive write that?" normally the answer is, "Yes."

The question, though, is should it? Does it provide value? That's where a vendor comes in and helps the client understand why they may or may not want to include a coverage.

Every year we do a benchmarking study for all of the captives that we manage, about 1,300 or so. We see, each year, the diversity of what the captives are writing tends to increase, premium volume-wise and also the new lines of business.

Some of the newer lines, like cyber, for example, and employee benefits, a decade ago were very small. Now, the clients and captives are writing more and more of these non-traditional lines in their captives.

View the video version of this interview at: http://www.ambest.com/v.asp?v=charnley820.

(By: John Weber: John.Weber@ambest.com)

August 14, 2020

Pinnacle's Walling: The Current Crisis Is 'Information Looking for Data'

The following is an edited transcript of the interview.

Rob Walling, principal and consulting actuary, Pinnacle Actuarial Resources, said insurance pricing was already shifting prior to the COVID-19 pandemic. Captives and other insurers need to revisit their enterprise risk management strategies to determine what gaps have emerged

Q: Rob, what impact is the global pandemic having on captive insurers?
A: It's really forcing almost every captive to be much more thoughtful in evaluating their insurance program and consider revising their coverage retentions, add coverages. We're seeing so many different coverages being impacted by COVID and the insurance market themselves also having an effect. So it's a very dynamic period in that there's no captive that's just renewing and expiring.

Q: Do you think the current economic downturn highlighted the need for ERM for captives?
A: Not so much the economic downturn, per say, but the cyclical turn in the insurance market, the hardening of the insurance market.

As I mentioned before, we're seeing reinsurance rates go up substantially. That was occurring even before COVID really came to roost in the US. But now, the additional claims associated with COVID are exacerbating the problem.

The economic conditions in the insurance market and in the reinsurance market are really highlighting the need for ERM. You're faced with a situation where you've got to decide between a 50 percent increase in your property insurance premiums or moving some of that coverage into a captive.

A lot of the ERM that's going on right now is really assessing the economic risks that keep you up nights -- that maybe you thought you had covered in a commercial insurance product or in a captive and maybe you didn't -- and rethinking how you design your overall risk financing program between your captive and the commercial policies you buy.

A lot of it, from an ERM perspective, is really taking a much more thoughtful look at the real-world risks that keep you up nights, that maybe you weren't as aware of six months ago. So it really is an opportunity to look at ERM through new eyes and with new information.

Q: Rob, do you think that the role of the actuary is more critical during times of economic uncertainty like right now?
A: I think there's an opportunity for an actuary to play a greater role. The question of whether the actuary steps up to that challenge remains to be seen, but there's certainly an opportunity.

A situation like the current crisis is information begging for data, and it's very challenging from a data perspective. There's not a lot in the actuarial toolkit that makes looking at the historical data and using it to accurately project what 2020 is going to look like an easy or routine process.

So actuaries are going to be asking more questions. They're going to be requesting more data, and they're going to be looking at the data differently than they would in a year that didn't have substantial external changes. But all of that dynamic environment certainly is an opportunity for the actuary to play a key role.

Q: What advice are you giving to captive managers right now that you probably weren't giving them a year ago at this time?
A: It's really important to be very intentional when we're going through these very dynamic periods. So, the more time that you can have for evaluating the insurance program, really understanding where your coverage gaps might be, having a thorough understanding about what the commercial markets are going to be doing with your renewals all go into the process of making sure that your overall risk financing program is well-designed.

Making sure that your coverage gaps that you've either known about for a time or identified through the COVID experience are being addressed, and making sure you're making the right financing decision between financing and exposure in a captive versus keeping it in the commercial insurance market.

All of that takes time, and all of that takes not just lead time on the clock, but actual time talking to the service providers, the captive managers, the actuaries, and getting the best information you can to make as good a risk decision as you can. to make as good a risk decision as you can.

View the video version of this interview at: http://www.ambest.com/v.asp?v=walling820.

(By: John Weber: John.Weber@ambest.com)

August 13, 2020

Vermont's Provost: In Time of Stress, Sponsors Tap Captives for Relief

The following is an edited transcript of the interview.

David Provost, deputy commissioner, Captive Insurance Division, Vermont, said some sponsors of captives domiciled in that state have turned to their captive to help alleviate financial crunches during the recent pandemic.

It's the time of the year when we talk about captive insurance, as this is traditionally the time of year for the Vermont Captive Insurance Association's annual conference. This year, however, the conference is virtual as a result of the pandemic. I'm speaking today to David Provost. Dave is the deputy commissioner for the Captive Insurance Division for the state of Vermont.

Q: Dave, let's start out by asking, how is the state of the captive market?
A: It is super busy. It is really hopping. The market had turned very hard for the property insurance over the last year. That's continuing, so we had a lot of new business coming in for July 1 renewals. We had some last minute plan changes. We have licensed 17 new captives already this year compared to six at this time last year.

It's hopping, and we still have new applications in the pipeline. We're looking for a very busy year. So far, so good.

Q: Is COVID having an impact on captives, Dave, such as what companies might be putting into their captives?
A: Absolutely. I'd have to say, it's probably having more impact on what's coming out of captives than what's going in. I think in the future we'll see more consideration for how do we deal with something like this the next time around with a captive.

For now, what we've seen is we had quite a few captives that, over the years, they built up surplus waiting for that rainy day. This was the rainy day for them.

We had one hospital group that had built up a lot more surplus than they needed in the captive. They asked if they could take a dividend to buy supplies and equipment. Absolutely.

We've got some pretty sad stories, as I'm sure you can imagine, where if we don't use some of this money we're going to be in trouble at the parent level. We obviously worked with companies to come up with an appropriate amount. We don't want to kill the captive, but if you kill the parent, you've done the same job.

Some companies have done great, as you can imagine. Anybody that's in the Plexiglas business is going great guns. Construction really hasn't seemed to stop much. I think everything took a stop for a while, but has picked up again.

Obviously, the recreation and hospitality industry is hurt the most. We have some ROGs that are focused on recreational activities that you just can't do during the pandemic. You can't be in close contact with people as personal trainers, or guides, or instructors in anything.

Those groups have struggled. At the same time, the exposure's cut off, too. They're sort of on hold. They've had a few cases where, again, if we can use some of the money we've built up in the captive to help support our members, it's going to be good for both members and the insurance company in the long run because if they don't survive, we don't survive.

Q: I was talking with Michael Pieciak a few weeks ago. As you know, Dave, he's the Vermont Insurance Commissioner. He was telling me about an insurance innovation sandbox in Vermont. What innovations are we seeing when it comes to captives?
A: We haven't actually had a application to use the traditional insurance sandbox, but what the sandbox does is gives you certain temporary waivers of some of the rules.

Captives have sort of been a sandbox of their own for the past 30 plus years where they don't necessarily follow the same rules. They have to follow solvency rules and sensibility rules, but they have their own rates and forms. They develop all of their own rates and they developed their own insurance forms.

That's where a lot of the innovation has come from in captives, but I've always said that the real innovation is at the parent level. Captives are solving a basic insurance problem. Most captives themselves look pretty plain vanilla. They may offer GL, as most captives do. It's the most popular line in captives in Vermont, anyhow.

That looks pretty plain vanilla. It's what the parent is doing is where the real innovation is. Sometimes the parents, using the money they've saved with the captive to help fund programs at the parent level. There's a been a number of groups...

This is usually the groups that do this kind of thing, where they build up surplus, again, and provide educational services to their members. We have some...One captive even had a television studio for a while and made their own videos to support the membership and show them how to implement proper safety protocol for their properties.

We have a number of captives in the health care industry that grant programs with the staff at the hospital. Apply for a grant with us and show us what your plan is. We will fund it so that you can try it out, test it out, and see if it works. That's where the innovation comes in, I think, is the benefit of having a captive is to give you some resources to do things at the parent level.

Q Between a pandemic, which doesn't seem to be going anyplace anytime soon, the presidential election, and I believe you have a gubernatorial election this year in Vermont, too.
A: We do.

Q: How is this year going to play out for captives, Dave?
A: I think it's going to continue going pretty strongly across the captive world. One of the things that a captive is great at is providing some certainty in your insurance market. Right now, the insurance market's a little crazy. If you crave certainty, well, then take control and start a captive of your own.

I think large companies and small are going to continue to look at captives as a source of reliable insurance helping cut their costs where possible and providing availability where that's an issue for quite a while.

I think that there's going to be, again, some looking at what the pandemic has done and using captives to help work on dealing with the next one because it will come again. Hopefully, not next year. Hopefully, not for another hundred years, but it's going to happen again. We'll see.

I think that that's where the captives are going to help out with providing a more certain environment to operate in for business.

View the video version of this interview at: http://www.ambest.com/v.asp?v=provost820.

(By: John Weber: John.Weber@ambest.com)

August 12, 2020

VCIA's Smith: Pandemic Shows Captives Can Better Respond to Sponsors' Risks

The following is an edited transcript of the interview.

Rich Smith, president, Vermont Captive Insurance Association, said market insurance products often exclude risks that captives are better positioned to cover.

This is the time of year when just about anybody who's anybody in the world of captive insurance gathers in Burlington, Vermont for the Vermont Captive Insurance Association's annual conference. The global pandemic, however, has put the kibosh on this year's event, and instead the conference has gone virtual.

I'm speaking today with Rich Smith, President of the VCIA.

Q: Rich, how difficult was it to turn the conference into a virtual event?
A: It certainly was difficult on two fronts. One is making the decision. As we were heading into March and April, we just realized that it was more and more unlikely that we'd be able to bring the folks we always bring to Vermont. We usually get around just over 1,000 people who come to Burlington, Vermont every summer for our conference.

With what was happening with the pandemic, it just looked like that was going to be a bridge too far. Even though it was a difficult decision because there was still a lot of unknowns, today it certainly looks like it was the right decision.

On the second front, we've been putting this conference on for over 30 years in Vermont, really was a well-oiled machine. What we had to re-learn or what we had to learn was how to put a virtual conference on while we were still building the content that we always provide to the captive insurance community.

It was a little bit like flying the airplane and fixing it all at the same time. We're still in that process. We feel really bullish that the platform we chose will be robust and provide that feeling of really being at a conference for our attendees.

Q: Beyond forcing the conference to go virtual, what impact has COVID-19 had on captives?
A: Obviously for every organization its impact is the ability to get business done in a normal fashion. Certainly that's had an impact.

The state has done a great job. The regulators in the state have done a great job in being flexible for the captive industry in terms of meeting requirements, and reports, and things like that. There's a flexibility and understanding within the industry to keep moving forward.

Obviously, it's impacting the organizations that captives insure. Whether they're utilizing the policies within their captives or not, it's certainly having a widespread impact from an economic basis.

Q: Rich, how are captive insurers responding to business interruption claims that might be different than how standard commercial insurers are responding?
A: Yeah, John. This is where captives can play a very unique role. As you know, captives are owned by the insured.

In traditional insurance policies, business interruption policies, generally pretty limited, obviously a lot of exclusions, pandemic being one of the big exclusions, certainly for good reason when you're trying as a traditional insurance company to create the actuarial science to provide those kinds of policies.

For a captive, which insure their owners, they're able to create bespoke policies that meet the needs of the particular captive or the particular organization. They have a better understanding of what those business interruptions could look like and can create the policies around that.

Q: Are you seeing captives being used differently as a result of the pandemic?
A: I am hearing that captives are being very flexible in trying to be very, take a look at what the pandemic is doing and then recreating or creating some new policies and some new ways to create those risk mechanisms they need for their owners. I'm actually excited because I think we're going to hear a lot more about that at our conference in terms of how captives have responded.

Certainly captives are looking at the pandemic. Obviously there was already a hardening of the traditional insurance market towards the end of the year. They've been looking at that and the pandemic and looking at how do they pivot, how do they create the risk mitigations they need for their owners.

Q: Rich, what are the goals and plans for the association as we move forward, and have those goals and plans changed really as a result of this pandemic?
A: Our overall goals and mission has not changed. We're looking to provide the education, the networking, and also the advocacy for the industry obviously here in Vermont but also more broadly. We're, I think like every organization, we're trying to figure out next steps.

Obviously the pandemic is creating a lot of uncertainty for our members as well as for us, but we feel pretty bullish that going forward we're going to be coming out of this, again fingers crossed that we'll have either a vaccine or there'll be some sort of let-up of the pandemic in 2021. Our plan is to keep moving forward.

Q: Rich, I can tell you a lot of people are going to miss that maple syrup and Ben & Jerry's.
A: We're going to miss all those people. We truly enjoy having all those. It's like a family reunion. You see old friends and new friends. That certainly is disappointing. Again, we're hoping we can create that, at least as much as possible, online, that virtual meeting place that I think the captive insurance industry needs at this point.

View the video version of this interview at: http://www.ambest.com/v.asp?v=rsmith820.

(By: John Weber: John.Weber@ambest.com)

August 10, 2020

AM Best's Teclaw: Cell Captives Provide Coverage Opportunities for Smaller Companies

The following is an edited transcript of the interview.

Dan Teclaw, senior financial analyst, AM Best, said overall financial results for AM Best-rated captives remain favorable.

With the Vermont Captive Insurance Associations Annual Conference upon us, it's a good time to see how AM Best rated captives are faring. With us to discuss the captive industry is Dan Teclaw, AM Best senior financial analyst.

Q: Dan, another year in which the rated portion of the captive industry did well compared to its commercial counterparts. What do you suppose is driving that?
A: This is typical I think for these captives, as we've seen for the past 20 years that we've been doing this report. All these stakeholders are pretty much aligned. Low loss ratios continue to drive a lot of the favorable results, since they're all aligned in managing risks, preventing risk, and resolving any type of claims they might have.

By virtue of being captive, they have low expense ratios. On the underwriting side, that's been pretty favorable. Results had been sliding a little bit in '18 and '19 after a lot of the CAT exposure or CAT events happened at the end of the year. They got resolved over '18 and '19, which were a little bit more typical years.

Ultimately, they ended up developing favorably compared to what was originally planned. I think those are the key things that have driven those results in that profitability.

Q: Is there any discernible impact from the pandemic on captives today, Dan? Do you think the crisis will spur some new strategies?
A: As part of our surveillance, we stay in contact with our rated companies. Even though we are third party and objective observers, we're still insiders so we can get pretty good information from them. We circulated a questionnaire that asked them how they were handling the pandemic operationally, and whether it impacted their business.

We've not really seen any impact at this point. Of course, it was early on and things are continuing to develop, but they haven't really had any type of layoffs or anything like that. Obviously, premiums are down and related to shutdowns and those type of things, the claims and frequencies are down as well.

Both costs and premiums will likely be down, but the profitability ratios will probably still be in line. With respect to new strategies, I think companies are continuing to look for new ways to either use their captives for new lines or to form new captives. At this point, we haven't really seen a lot of that yet.

I think there'll obviously be some consideration for how they will manage their BI risk or business interruption going forward, as well as whether they will keep retentions and those type of things. Certain structures are also being floated or bandied about, I guess you would say, with some cell captives.

We're seeing some of those come in actually for ratings. That gives smaller companies opportunities to self insure, but at the same time, they give a third party view on loss mitigation and control.

That's what a lot of these companies really need and want, in order to save some loss cost that would go into the commercial market, and save it for the rainy day loss that might be unexpected, even if it's not that large. Typically they're for larger unexpected losses.

Q: Besides the pandemic, Dan, are there any particular challenges or headwinds that captives are facing?
A: I would say, just similar to a lot of other companies, the captives are also charging actuarially needed type of rates in order to preserve the strength of their balance sheets to cover losses that they may need. If there's a harder market for various types of coverages, those will need to be adjusted.

We don't see a lot of adjustment typically, because it's internal and they are able to manage that at arm's length between the captive and the parent. Also, though, I would think that one third of their income typically is in the investment market. To the extent that rates stay low, I think that will be a challenge for some of them.

All those things being said, they're able to manage their losses and underwriting profitability so that there are significant dividends being repaid. Those can also be a lever they can pull to either keep capital or return capital if they would need to.

Q: Are there any domiciles that stand out to you in terms of their activities, and also against the backdrop of the VCIA Conference? Is there anything new with Vermont's position among domiciles?
A: Not surprisingly, Vermont continues to have the oldest or the leading type of regulatory framework, since it's the oldest and most established. I think a lot of companies that are looking for captive domiciles are looking for regulators that are responsive, and understand their business flexible and that type of thing.

We've seen more activity in like Utah or Tennessee, and in some of those type of domiciles, but Vermont is still the largest of all these. They have gone further this year in improving their framework, to try to add or lineup reporting with NAIC type of requirements, so it's better that way.

They're also introducing capital requirements, adjusting those type of things for smaller or cell captives. We're seeing them adjust in that regard. I think they continue to modify and improve their regulatory framework, and they're all pursuing new business to bring into their own domiciles. We see that as favorable and we keep up our relationships with the regulators as well.

View the video version of this interview at: http://www.ambest.com/v.asp?v=ambcaptives820.

(By: John Weber: John.Weber@ambest.com)

July 29, 2020

Pandemic, Shifting Commercial Market Create Openings for Captive Insurers

The impacts of the COVID-19 pandemic, combined with an already-shifting commercial insurance market, are driving increased interest in captive insurance organizations, a panel of captive insurance experts and rating analysts said. Panelists appeared in the AM Best Webinar, “Market Dislocation Creates Opportunities for Captives.”

Pamela E. Davis, founder, president and chief executive officer, Nonprofits Insurance Alliance, an insurer that includes a risk retention group, said activity spiked in recent months as nonprofit service and support organizations saw demands on them rise with the shutdowns. Meanwhile, those organizations were seeing nonrenewals and large increases in the cost for coverage from insurers in the traditional insurance market. “It’s hitting them right at the time that they’re struggling with COVID-19,” Davis said.

Fred Eslami, associate director, AM Best, said policyholder surplus for AM Best-rated U.S. captives increased from $21 billion in 2015 to nearly $25 billion in 2019. AM Best analysis of innovation showed that 84% of U.S. captives were scored as “moderate,” with 88% of risk retention groups receiving that same designation, according to webinar exhibits.

Regulators have been instrumental in allowing captive organizations to serve the risk needs of their sponsors, Susan Molineux, director, AM Best, said. Molineux mentioned Vermont as an example of a regulator who regularly refines their legislative framework to achieve this result.

The IRS remains committed to scrutinizing 831(b) “microcaptives,” who under this section of the Internal Revenue Code, pay tax only on their investment income. In order to demonstrate the legitimacy of these companies, microcaptives and captives of all sizes should be prepared to demonstrate that risk transfer, risk distribution and arm’s length pricing are in place.

Michael Serricchio, managing director, Marsh Captive Solutions, said some captives managed by the firm already had pandemic insurance. Meanwhile, many companies are looking to launch captives to include coverage of directors & officers liability, product liability, excess coverage and other lines. About one-quarter of the organizations Marsh is working with already sponsor at least one captive, and the remaining three-quarters are forming new captive vehicles, he said.

Eslami said AM Best in recent months has been conducting stress tests and reviewing all of its rated insurance companies, including captives. So far, reviews based of rated captives based on Best’s Capital Adequacy Ratio have not shown material changes, although some captives did have large financial commitments to their parent organizations. However, the tests have not led to significantly changed rating evaluations, Eslami said.

About 15% of rated captives cover cyber liability, Eslami said. Given relatively attractive pricing for cyber cover, along with the sophistication required to underwrite it properly, cyber-related premiums to captives dropped by 5% in the latest full year, Eslami said. Serricchio said he expects captives to continue to cover cyber, an amount likely to rise over time.

Davis said she supports proposed legislation that would permit risk retention groups to expand the Liability Risk Retention Act to allow risk retention groups to offer property coverage to nonprofits that can’t find adequate stand-alone coverage in the general market. She noted that the demand for coverage from the RRG has increased dramatically this year because commercial carriers are leaving the nonprofit market, indicating the RRG expects to grow by 25% or more this year. Meanwhile, all nonprofits are facing greater pressures, Davis said. “We know we’re going to lose some of our members. They’re resilient, but they are struggling.”

To view the panel, visit: http://www.ambest.com/video/Video.aspx?rc=299680.

(By: Lee McDonald: Lee.Mcdonald@ambest.com)

August 4, 2021

Captives' Flexibility and Control Enable Them to Outperform Commercial Peers

COVID-19 pandemic provides captives with both challenges and opportunities

Over the past 21 years, the operating performance of the US captives rated by AM Best has readily surpassed that of their commercial market peers. Their inherent flexibility and control in managing risk drives profitability and retained earnings, while creating value for their policyholders and stakeholders, regardless of market conditions. This pattern has been evident since the formation of the first captive and the principles supporting this construct remain the same in 2021. The term "captive" was coined in the 1950s by Fred Reiss, known as the "father of captive insurance," who formed American Risk Management in 1958. During this time, US regulations made it prohibitively expensive to form and operate captives in the US. In 1962, Bermuda assisted Reiss in forming what is believed to be the first modern day captive.

For captive insurers, COVID-19 brought forth a new set of challenges but also new opportunities, particularly for insureds seeking to include coverages for communicable diseases as part of their commercial property policies, including business interruption and contingent business interruption. To date, most AM Best rated captives have not been significantly affected by the pandemic and for the most part were not immersed in coverage disputes nor materially affected by the slowdown in economic activity during this period. And while some captives had pandemic-related coverages within their policies, no significant amounts within our rated captives have been triggered under policy definitions.

Although loss frequency has slowed in parallel with the broader economic slowdown during the pandemic, for some captives, increased loss severity trends (e.g., commercial auto and medical professional liability) have yet to subside. Since many of the courts in the US were closed for an extended period, it remains to be seen where severity trends may end up for 2021. However, many experts believe social inflation and loss severity are here to stay. Loss frequency will also rise as a consequence of improving macroeconomics. In addition to addressing COVID-19 challenges, through the past year the commercial insurance market has continued to harden, reflecting conditions similar to periods that first gave rise to the use of captives—most notably in the 1960s, and again in the 1980s, when the Liability Risk Retention Act (LRRA) became law. What makes this even more challenging for captives is the increased cost of reinsurance. Over the last two years, reinsurance pricing increased as reinsurers tried to maintain their expected margins by staying ahead of rising natural catastrophe activity and a protracted period of low interest rates. The convergence of these factors has made it very difficult for captives to hold the line on pricing. The placement of reinsurance has prompted some to expand the use of their existing captives, form new captives, or a combination of both, as part of their risk management strategies. As a result, captives are balancing risk appetites with self-insurance savings to determine whether, or how much, to increase net retentions or to participate in the reinsurance tower to manage costs. Firming commercial insurance prices and reinsurance capacity shortages are examples of recent market developments that are contributing to market dislocation and could continue for years to come.

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The captive segment was created to address periodic availability and affordability crises for certain risks. The segment evolved over time from a simple single parent structure to more complex entities with multiple owners that want to share best practices in loss sharing and risk management to the economic benefit of policyholders and shareholders. Each structure is unique in its stakeholders, policyholders, and the risks they write and how they write them. In common, they all function as risk transfer vehicles for the policyholders. AM Best has significant experience in rating many of these structures, running the gamut from the large single parent structures that have significant surplus to cover low-frequency, high-severity risks to risk retention groups (RRGs) and exchanges comprised of small like-minded enterprises, seeking professional insurance risk management and loss control for more affordable risk-sharing. It's not that they don't get to the commercial market and, ultimately, reinsurance market. When they do, they are in a better position to purchase needed coverage on a more affordable basis. The SPCs generally have capital to retain larger amounts of risk for catastrophic risks. Policyholders for group captives, RRGs, and exchanges, on the other hand, still participate in the traditional market, but as a group of policyholders buying limits in an adequate working layer on a more affordable and efficient basis with better representation for further coverage in the reinsurance market .

Hardening markets present opportunities for new structures. The cell structure is being more broadly developed under various names such as Segregated Account Company, Segregated Portfolio Company, Protected Cells, or Incorporated Cells. For owners of small to medium-sized enterprises across a wide variety of industries and businesses, cell companies may provide general business protection. Some captive managers and professional insurance management teams offer a platform or access to a risk pool under a tightly written policy with a broad menu of coverages, ranging from active shooter to small airplane coverage, all of which are covered under the same risk pool despite the variety of claims. No financial support is commingled. Policyholders stand on their own with regard to capital, financial condition, and operations. They are "only" required to share losses under the terms of the pool and, in most cases, provide ongoing proof of financial wherewithal and viability, as well as collateral.

These entities are all regulated in varying degrees by current regulations of the existing insurance departments. Business plans are registered and reviewed by regulators and guidelines for minimum capital are established, giving captives flexibility to create forms and pricing tailored to their own risks and risk tolerances.

This environment enables captives to customize coverage for risks that may be uncommon or difficult to write or place in the standard market. To their benefit, they can then decide what self-insured retention they prefer, whether to provide coverage as deductible reimbursement, what reinsurance limits to purchase, what level of reinsurance participation (if any) is appropriate, and what coverages to include or exclude (e.g., pandemic, communicable disease). Excluded coverages may be addressed more efficiently by the parent outside the captive in the traditional market.

Historically, captives have focused on providing coverage for exposures unavailable in the commercial market. According to Strategic Risk Services, these exposures include "warranties and service contracts, healthcare capitation risks covering services exceeding an obligated or fixed service cost amount, and medical stop loss coverage. Although not new types of risk, some other areas of growth include using captives to access the federal terrorism risk pool and to plug holes in exclusions on property policies. Lastly, health systems and hospitals are using their captives to set up onshore risk retention groups to address the expanding needs of hospital-employed physician groups."

Captives—particularly, single parent captives (SPCs)—are exploring coverage for employee benefits and medical stop loss to improve the overall health and well-being of workers and to cut overall medical costs. Rising health insurance costs are supporting an increase in medical stop loss writings, as more companies look to self-insure employee health insurance plans (both SPCs for larger employers and group captives formed by medium-sized employers). Interest in third-party stop loss coverage and broker-sponsored programs to supplement major medical coverage owing to high deductible plans also continues to grow.

Captives offer capacity retention for unavailable lines, providing a tool to complement commercial buying decisions, focused more on price and terms than availability. Captives may also provide an opportunity to write traditional lines of business where rates have climbed following catastrophe losses as well as for ongoing uncertainty related to COVID-19. Rate increases for lines such as D&O, E&O, and commercial auto may spur captive interest and help reduce claims costs. For medical professional liability (MPL) insurers, excess capital can help expand market share and diversification through M&A or joint ventures, or by forming Alternative Risk Transfer (ART) vehicles. Rate flexibility, however, is the key reason that the use of ART vehicles will likely continue to grow over the near term for the MPL segment.

Number of Captives Continues to Evolve

More difficult commercial market conditions typically benefit the captive segment and provide the incentive for businesses to consider establishing them. In hard markets, certain non-insurance companies may feel the commercial market does not understand and/or overprices their view of their own risks so they investigate forming captives. In other instances, smaller organizations in a similar industry (e.g., colleges/universities, farm cooperatives, not-for-profits, housing authorities, medical professionals, trucking companies) may band together to cost effectively share risks through a group captive, RRG, or exchange, through which they can then also efficiently face the reinsurance market. On the other hand, when market conditions ease or normalize, the use of certain types of captives can become a less compelling alternative to the traditional commercial market.

The number of US domestic captives declined marginally from 3,182 in 2019 to 3,107 in 2020, a -2.4% change. Increased scrutiny by the IRS regarding 831b's and the rise in economic uncertainty from the pandemic during the first half of 2020 likely drove the modest decline through a small quantity of captive closures as well as a reduced number of new formations. As economic activity and confidence resumed, and the hardening insurance market persisted, the flexible, adaptable, and innovative solutions that captives afford their owners continued to prevail. As a result, there was an increase in captive applications in late 2020 and early 2021, with a growing interest in captive cells as a more expeditious and efficient solution in a challenging market. Cells effectively borrow a third party insurance management and licensing platform to address certain risk transfers more quickly, with smaller amounts of capital investment, and gain professional oversight so they don't have to take their eyes off the primary business that they are insuring. Further, these are easier to close (or go dormant) when a hard market softens or when a business sponsoring a cell closes or sells. They are also able to restart should a market turn again or should another business need arise if they have left their capital in the cell, which many do for a period of time since distribution is a taxable event.

Exhibit 1 lists the number of active US captive domiciles with more than 100 captive insurers. AM Best rates more than 200 global captive insurers in a variety of jurisdictions with a diverse range of industries and risk profiles. **Exhibits 2** and **3** show the domiciles and types of AM Best's rated captive universe.

Year over year, a consistent result highlighted in this report has been excellent operating performance. **Exhibit 4** looks at a few key performance metrics and is an illustration of just how well US captives compare against the commercial insurance market. As the exhibit shows, the five-year average combined and operating ratios of the rated US captives again outperform those of its commercial casualty peer composite (CCC) by wide margins. Exhibit 4 breaks down these metrics for SPCs, RRGs, and total rated captives (CIC) against the CCC's five-year average ratios.

This outperformance also translates into substantial long-term profits and surplus gains. As **Exhibit 5** shows, the rated US captives in aggregate increased their policyholders' surplus by $3.4 billion, despite returning $5.2 billion to their stockholders and policyholders from 2016 through 2020. This reflects $8.6 billion in savings that captives generated over that period for their own organizations, by not purchasing insurance from third parties in the commercial market.

Rated Captives: Financial Results and Statistical Analysis

Although captive insurers are alternative risk finance vehicles and are not intended to be profit centers, they typically create natural efficiencies that often result in significant underwriting profitability and overall earnings. Underwriting profit can be viewed as the insurance expense savings that stakeholders would otherwise pass on to traditional commercial insurers. As such, retained earnings through profits remain the pronounced driver of capital growth for the group, as **Exhibit 6** shows. The five-year average compound annual growth rate for the group is 3.9%. The CAGR includes changes in unrealized capital gains; the fourth quarter market correction in 2018 and subsequent recoupment in the first half of 2019 largely offset, with realized and unrealized capital gains settling at a more moderate level in 2020.

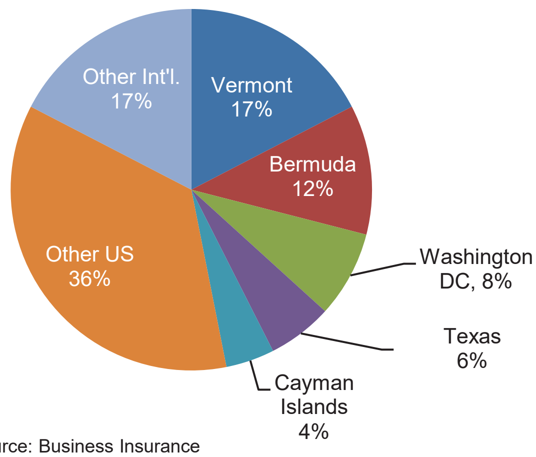
The rated US captives in AM Best's captive insurance composite (CIC) reported another strong year, with a pretax operating income

Exhibit 1
Number of US Captives, 2020

Rank	US Domiciles	2020
1	Vermont	589
2	Utah	396
3	Delaware	288
4	North Carolina	250
5	Hawaii	242
6	Tennessee	212
7	South Carolina	175
8	Nevada	166
9	Arizona	131
10	Montana	114
11	Wash. DC	106
	Other States	438
Total		**3,107**

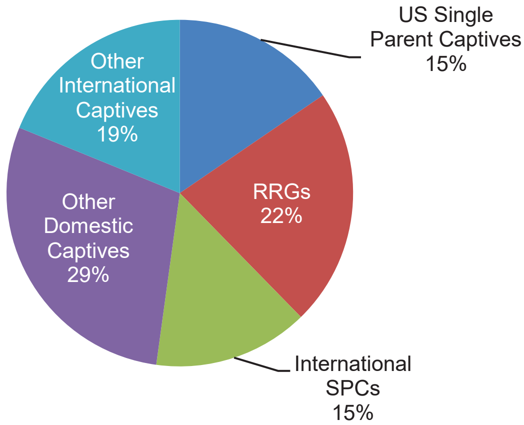
Source: Business Insurance

Exhibit 2
AM Best's Rated Global Captives – by Domicile



Source: Business Insurance

Exhibit 3
AM Best's Rated Global Captives – by Type



Source: Business Insurance

of $942 million. This was down modestly from the $1.01 billion reported in 2019, although it once again readily outperformed the CCC by a wide margin on a ratio basis.

Exhibit 4
US CIC – Five-Year Combined Ratios, 2016-2020
(%)

	5-Year Combined Ratio (Ex Div)	5-Year Operating Ratio
SPCs	73.2	54.2
RRGs	95.3	84
All Captives (CIC)	**83.4**	**76.5**
5-Year CCC	**100.7**	**88.7**

Source: BESTLINK

In 2020, the combined ratio (post-dividends) of captive insurers improved by 4.1 points to 97.9 from the 102.7 that was recorded in 2019. The improvement reflects incremental progress toward the very strong profitability recorded in years prior to the resurgence of natural catastrophes late in 2017 after several benign years. Policyholder dividends also moderated in 2020, both nominally and as a percentage of earned premium. The net result in 2020 has been a return to underwriting profitability, supplemented by moderate net investment income (from lower returns on larger portfolios) and capital gains to grow surplus even while returning a solid level of dividends to stockholders.

Exhibit 5
US CIC – Policyholders' Surplus
($ millions)

	2016 PHS	2020 PHS	Increase	Stock and Policyholder Dividends	Total Savings
SPCs	9,825	11,384	1,559	1,755	3,314
RRGs	2,425	2,946	521	359	880
All Other Rated Captives	**11,287**	**12,575**	**1,288**	**3,089**	**4,377**
Total Rated Captives	**23,537**	**26,905**	**3,368**	**5,203**	**8,571**

Source: BESTLINK

Investment Returns Remain a Challenge

Investment returns remain a challenge for captive insurers, as they do for commercial insurers. In 2020, net investment returns decreased slightly, which, combined with lower capital gains, decreased the total investment returns to 3.8% from 6.2% in 2019. Captives realized capital gains of $344 million and recorded unrealized gains of $300 million from the equity markets. All of the unrealized losses from the pandemic-related sell-off in March 2020 were recouped by the end of 2020, as they were in 2019 after the market correction late in 2018. Fixed income investments continue to generate low returns in the persistent low interest rate environment and they comprise the large majority of captive unaffiliated investments. Net investment income has remained a strong contributor to operating profits, despite weaker returns on growing investment portfolios.

Capital preservation is a primary goal for captives, which they achieve in a number of ways, including strict and conservative investment practices. For many SPCs, invested assets are composed almost entirely of loan-back arrangements with the parent. They generate net investment income, usually based on a benchmark rate plus a risk factor, or on the parent's outstanding commercial paper base rates. In general, however, captives do not emphasize investment returns as much as they do risk transfer and capital preservation. Therefore, these measures usually trail the CCC's.

Captive insurers remain nimble and stable overall despite investment market conditions such as persistently low interest rates and the recent turbulence in equities. Captives tend to stay

Exhibit 6
US CIC – Financial Indicators, 2016-2020
($ millions)

Year	Net Premiums Written	% Change	Pretax Operating Income/ Loss	% Change	Net Income/ Loss	% Change	Admitted Assets	% Change	Loss & LAE Reserves	% Change	Year End Surplus	% Change
2016	5,031	2.8	1,633	12.0	1,421	15.0	40,217	5.4	9,572	0.7	23,537	5.8
2017	4,869	-3.2	1,348	-17.5	1,349	-5.0	40,806	1.5	9,930	3.7	24,301	3.2
2018	5,104	4.8	1,209	-10.3	1,118	-17.1	40,772	-0.1	9,927	0.0	24,588	1.2
2019	5,389	5.6	1,015	-16.1	1,281	14.5	43,052	5.6	10,269	3.4	25,881	5.3
2020	5,445	1.0	942	-7.2	1,176	-8.2	44,571	3.5	10,696	4.2	26,905	4.0
5 Yr. CAGR		**2.1**						**3.2**		**2.4**		**3.9**
5 Yr. Chg.		**11.2**						**16.8**		**12.6**		**21.0**

Source: BESTLINK

Exhibit 7
US CIC – Ratio Analysis, 2016-2020
(%)

	Loss & LAE	Underwriting Expense	Combined (Ex Div)	Policyholder Dividends	Investment	Operating
2016	59.7	19.1	78.8	5.3	16.5	67.6
2017	63.3	19.9	83.2	9.6	18.8	74.0
2018	63.8	19.3	83.1	12.9	19.8	76.1
2019	66.1	18.9	85.0	17.0	20.1	81.9
2020	68.3	18.2	86.5	11.4	15.7	82.2
5 Yr. Avg. (CIC)	**64.3**	**19.1**	**83.4**	**11.3**	**18.2**	**76.5**
5 Yr. Avg. (CCC)	**70.7**	**29.9**	**100.7**	**0.3**	**12.3**	**88.7**

Source: BESTLINK

away from alternative investment strategies despite the low interest rate environment. SPCs are under less pressure to utilize pricing strategies to overcome shortfalls in investment income; as a result, their rate management is generally more stable, and premium rates tend to line up with loss costs.

AM Best monitors captives' investment portfolios, diversification efforts, and strategies. Some of the key factors contributing to the rated captives' success are strong risk management capabilities and strict loss control programs, providing an edge when it comes to emerging risks. These insurers have an exceptional ability to identify areas of emerging risk quickly, owing to their extensive, in-depth knowledge of the risks they insure, as well as the homogeneous nature of these risks.

Policyholder retention is also key to captives' success. For group captives and RRGs, policyholder retention is typically very high, resulting in lower acquisition costs. SPCs are insulated from such shopping, while group captives and RRGs focus their energies on loss prevention and loss mitigation, leading to better results, a greater value proposition for both parties, and less-cyclical pricing, in addition to lower acquisition costs.

Ratio Analysis: Captive Insurance Composite vs. Commercial Casualty Composite

Exhibit 7 depicts our comparison of the YoY results of the AM Best rated US captives in the CIC to companies in the CCC, which shows some variability, albeit minimal, from one year to the next. The uptick in the loss & loss adjustment expense (LAE) ratio over the last two years was driven primarily by the effects of social inflation and rising loss costs on the MPL line and, to a lesser extent, by the impact of catastrophe events of the past few years. However, in 2020, the underwriting expense ratio improved from 18.9 to 18.2, resulting in a combined ratio before dividends of 86.5. The policyholder dividend ratio of 11.4 led to a combined ratio after dividends of 97.9, compared to 102.0 in 2019.

The CIC's results continue to outpace the CCC's underwriting and operating results by a wide margin. The five-year average combined ratio after dividends was 6.2 percentage points better than the CCC's 100.9. Further, the CIC's metrics outperform the CCC's in almost every financial category with the exception of loss adjustment expense.

The reasons for the CIC outperforming the CCC remain largely the same:

- Controlled costs
- Focused underwriting
- Efficient and innovative management and mitigation of risk
- Robust loss control and risk management practices
- Flexibility in reinsurance purchasing

Captive insurers focus more heavily on loss control and capital preservation than on generating high rates of return and they are not intended to be profit centers. However, it is likely that the CIC's 2021 results will continue to trend favorably relative to the CCC, excluding any unforeseen circumstances such as large, industry-wide catastrophes.

A comparison of metrics shows that the CIC's return on revenue (ROR) was higher than the CCC's, as reflected in the CIC's five-year average ROR of 28.6% versus the CCC's 10.5% (**Exhibit 8**). The revenue returns readily outperform the CCC's since premium levels are lower, given the captives' mission. Conversely, because of the captives' strong capitalization, their 5.9% return on equity trails the CCC's 8.5%. Finally, the CIC's policyholders' dividend payments—a key tool to maintain high retention levels—are high in comparison to the CCC's. These trends remain consistent with what we have seen historically.

Another advantage captives inherently have over their commercial counterparts is a significantly lower underwriting expense ratio. Although other operating expenses are lower, the true expense advantage comes from the CIC's lower net acquisition expenses, because substantially all of the rated captives in the composite write business on a direct basis, with just some incidental expenses recorded for commissions. For captives that are heavy reinsurance purchasers, a portion of this savings is related to ceding commissions. Therefore, 2020 marks the fourth consecutive year of a declining underwriting expense ratio (**Exhibit 9**) for the CIC. In 2017, the reported ratio was 19.9%, and through 2020 improved to 18.2%. The five-year average ratio for CIC is approximately 19%, significantly lower than their commercial counterparts whose average is approximately 30%. The 11-point difference in expense savings is a sizable advantage for the CIC, especially at a time when underwriting margins in the commercial market are challenged and investment income remains variable.

CIC's net investment income for 2020 was $819 million, compared to $1.06 billion in 2019. Net investment yield declined from 2.8% in 2019 to 2.0% in 2020. This compares unfavorably against CCC's net investment yield of 3.3% for 2020. Despite the decline in investment income, consistent investment allocations and strategies appear to remain in place across the CIC.

Exhibit 8

US CIC vs. CCC – Profitability Analysis, 2016-2020

(%)

Year	Inv Yield	NII (W/ RCG)	Total ROIA	POI/ NPE	NI/ NPE	Total ROR	POI/ PHS	NI/ PHS	Total ROE	Loss & LAE	Under-writing Expense	Operating Ratio
2016	2.3	3.1	3.5	32.8	28.5	30.4	7.1	6.2	6.6	59.7	19.1	67.6
2017	2.5	3.7	4.9	27.1	27.2	35.7	5.6	5.6	7.4	63.3	19.9	74.0
2018	2.6	2.9	1.1	24.1	22.3	9.8	4.9	4.6	2.0	63.8	19.3	76.1
2019	2.8	4.1	6.2	19.3	24.3	38.6	4.0	5.1	8.1	66.1	18.9	81.9
2020	2.0	2.9	3.8	18.1	22.6	28.3	3.6	4.5	5.6	68.3	18.2	82.2
5 Yr. Avg. (CIC)	**2.5**	**3.4**	**3.9**	**24.2**	**24.9**	**28.6**	**5.0**	**5.2**	**5.9**	**64.3**	**19.1**	**76.5**
5 Yr. Avg. (CCC)	**3.7**	**4.0**	**4.2**	**10.6**	**9.9**	**10.5**	**8.6**	**8.0**	**8.5**	**70.7**	**29.9**	**88.7**
10 Yr. Avg. (CIC)	**2.5**	**3.3**	**3.8**	**26.1**	**25.3**	**28.3**	**5.8**	**5.6**	**6.3**	**64.5**	**18.8**	**74.5**
10 Yr. Avg. (CCC)	**3.9**	**4.4**	**4.4**	**11.9**	**11.9**	**11.6**	**9.0**	**9.0**	**8.8**	**70.8**	**30.1**	**87.7**

RCG = Realized capital gains

Source: BESTLINK

Exhibit 9

US CIC vs. CCC – Underwriting Expense Analysis, 2016-2020

(%)

	Commission Expense Ratio		Other Expense Ratio		Total Underwriting Expense Ratio	
Year	US CIC	CCC	US CIC	CCC	US CIC	CCC
2016	2.3	11.8	16.9	18.8	19.1	30.5
2017	1.2	11.5	18.7	18.6	19.9	30.1
2018	1.6	13.0	17.7	16.8	19.3	29.8
2019	1.9	13.3	17.0	16.9	18.9	30.2
2020	1.5	12.8	16.7	16.5	18.2	29.3
5 Yr. Avg.	**1.7**	**12.5**	**17.4**	**17.4**	**19.1**	**29.9**

Source: BESTLINK

The CIC's bond allocation remains slightly under 50% and total stocks around 13% of invested assets. Captives (most notably in the case of SPCs) are more likely to hold less in bonds due to loan-backs with their parents.

Finally, loss reserve development remains favorable, with CIC generating reserve redundancies in each of the last 10 years. A significant portion of this favorable development is in the medical malpractice and general liability lines.

SPCs Remain Profitable

AM Best currently rates more than 60 SPCs, over half of which are domiciled in the US. SPCs, however, can be domiciled practically anywhere in the world, but typically the parent organization seeks a domicile with a regulatory environment that is favorable to the formation and operation of the captive, as well as to capital management, fungibility, and eventual repatriation. These captives are generally subsidiaries of publicly traded, established, non-insurance corporations whose specific operating and asset/property risks can be efficiently tailored to manage through an SPC. The SPC segment has seen several years of sustained growth, both in terms of the number of new formations and premiums written, primarily due to the hardening market conditions. It is evident that companies are taking a more active role in both the management and financing of their organization's risks, which a captive provides them the opportunity to do. Although this report focuses on the results of the rated US SPC segment, many of the themes are global. **Exhibit 10** shows the key financial indicators for the segment, and **Exhibit 11** provides the profitability analysis.

The rated SPCs saw modest surplus growth in 2020, but they constitute a substantial portion of the CIC, accounting for 42% of the composite's surplus and 39% of written premiums. The segment continues to generate surplus growth through its profitable operating results, which is primarily due to its consistent underwriting profitability, supplemented by predictable net investment income from conservatively invested portfolios. Nevertheless, surplus growth has been limited by the rise in returned capital in the form of stockholder dividends. In the previous five years, SPCs have generated over $1.6 billion in surplus growth, despite returning nearly $1.8 billion in stockholder dividends. In 2018, dividends were on the low side, as enterprises retained capital in their captives while they settled substantial CAT losses from late 2017 and early 2018.

Exhibit 10

SPC Composite – Financial Indicators, 2016-2020

($ millions)

Year	Net Premiums Written	% Change	Pretax Operating Income/ Loss	% Change	Net Income/ Loss	% Change	Admitted Assets	% Change	Loss & LAE Reserves	% Change	Year End Surplus	% Change
2016	2,003	1.0	943	2.6	693	1.2	16,416	7.4	3,125	0.1	9,825	5.9
2017	1,945	-2.9	941	-0.2	764	10.2	16,107	-1.9	3,511	12.4	10,019	2.0
2018	2,012	3.4	850	-9.7	693	-9.3	16,700	3.7	3,579	1.9	10,629	6.1
2019	2,105	4.6	1,045	22.9	890	28.4	17,150	2.7	3,680	2.8	11,005	3.5
2020	2,147	2.0	967	-7.5	842	-5.4	17,399	1.5	3,667	-0.4	11,384	3.4
5 Yr. CAGR		**1.6**						**2.6**		**3.3**		**4.2**
5 Yr. Chg.		**8.3**						**13.8**		**17.4**		**22.7**

Source: BESTLINK

Exhibit 11

SPC Composite vs. CCC – Profitability Analysis, 2016-2020

(%)

Year	Inv Yield	NII (W/ RCG)	Total ROIA	POI/ NPE	NI/ NPE	Total ROR	POI/ PHS	NI/ PHS	Total ROE	Loss & LAE	Under-writing Expense	Operating
2016	2.2	2.5	2.5	47.8	35.1	34.5	9.9	7.3	7.1	56.8	11.2	53.1
2017	3.0	3.7	3.6	46.1	37.4	36.6	9.5	7.7	7.5	65.1	10.8	55.6
2018	2.9	2.9	2.7	43.5	35.4	34.2	8.2	6.7	6.5	68.1	10.3	57.3
2019	3.2	3.6	3.6	50.9	43.3	43.8	9.7	8.2	8.3	65.0	10.1	52.2
2020	2.0	2.4	2.6	48.6	42.3	42.4	8.6	7.5	7.5	60.1	8.2	53.0
5 Yr. Avg. (SPC)	**2.7**	**3.0**	**3.0**	**47.4**	**38.7**	**38.4**	**9.2**	**7.5**	**7.4**	**63.1**	**10.1**	**54.2**
5 Yr. Avg. (CCC)	**3.7**	**4.0**	**4.2**	**10.6**	**9.9**	**10.5**	**8.6**	**8.0**	**8.5**	**70.7**	**29.9**	**88.7**

RCG = Realized capital gains.

Source: BESTLINK

Several elements continue to contribute to the SPCs' profitability:

- Lower total cost of risk relative to traditional commercial insurance coverage
- Stable premiums
- Efficient management of parent and affiliated companies' losses and underwriting expenses
- Flexibility that minimizes the impact of commercial market insurance cycles and diminishes pricing volatility

Net premiums written for SPCs grew 2% in 2020, and have been relatively flat over the previous five-year period, with a five-year average increase of 1.6%. Loss and LAE reserves decreased 0.4% in 2020, which reversed a previous three-year trend of increasing reserves. Prior to 2020, reserves had been growing due to increased retentions, social inflation, and substantial CAT activity (e.g., 2017). Overall, the performance of these captives has remained very stable, consistent, and largely predictable. Non-insurance parents typically offer financial flexibility and capital support, should a captive require it to cover an occasional low-frequency, high-severity event.

RRGs' Underwriting Performance Improves

AM Best rates almost 50 RRGs. These entities have consistently accounted for approximately 16% of the rated captives' net premiums. **Exhibit 12** shows the key financial indicators for the segment. RRGs had break-even underwriting results in 2020, after two consecutive years of underwriting losses. The improvement in results was driven by a 2.5-point decrease in the expense ratio, following a significant increase in net premiums written during the year. This was, however, slightly offset by a 1.2-point increase in the RRGs' loss & LAE ratio, the third consecutive year of increases due to ongoing competitive pricing pressure.

The increase in the loss & LAE ratio occurred despite 6 points of favorable reserve development in 2020. RRGs have experienced double digits of favorable reserve development in eight of the past ten years. Conservative management teams emphasizing stability, insurance, and loss control versus profitability have driven loss picks that have been 10 points higher than those of the CCC but have developed favorably by approximately 13 points, to ultimately beat the industry's calendar-year loss ratios by about 2 points (**Exhibit 13**). The expense ratio is about 5 points better than the industry's, even including their costs of about four points in competing for new and existing business (versus the industry's 0.3).

Exhibit 12

RRG Composite – Financial Indicators, 2016-2020

($ millions)

Year	Net Premiums Written	% Change	Pretax Oper Income/ Loss	% Change	Net Income/ Loss	% Change	Admitted Assets	% Change	Loss & LAE Reserves	% Change	Year End Surplus	% Change
2016	730	0.5	125	-13.4	121	-12.3	4,784	6.1	1,602	7.0	2,425	5.8
2017	654	-10.5	127	1.4	130	7.4	4,829	0.9	1,538	-4.0	2,490	2.7
2018	726	11.0	100	-21.3	90	-30.7	4,899	1.5	1,592	3.5	2,464	-1.0
2019	801	10.4	123	23.3	166	83.6	5,315	8.5	1,661	4.3	2,739	11.1
2020	884	10.4	123	0.0	166	0.1	5,727	7.8	1,771	6.6	2,946	7.6
5 Yr. CAGR		**4.0**						**4.9**		**3.4**		**5.1**
5 Yr. Chg.		**21.7**						**27.1**		**18.3**		**28.5**

Source: BESTLINK

Exhibit 13
RRG Composite vs. CCC – Profitability Analysis, 2016-2020
(%)

Year	Inv Yield	NII (W/ RCG)	Total ROIA	POI/ NPE	NI/ NPE	Total ROR	POI/ PHS	NI/ PHS	Total ROE	Loss & LAE	Under-writing Expense	Operating
2016	2.3	2.8	3.6	17.0	16.5	19.6	5.3	5.1	6.1	67.7	26.9	84.1
2017	2.1	2.7	4.5	19.6	20.2	31.0	5.2	5.3	8.1	60.8	30.1	80.7
2018	2.4	2.4	0.3	14.1	12.7	2.3	4.0	3.6	0.6	69.7	28.0	86.1
2019	2.7	4.2	7.6	15.8	21.3	38.3	4.7	6.4	11.5	70.3	26.9	84.2
2020	2.3	3.6	5.8	14.7	19.9	31.2	4.3	5.8	9.2	71.5	24.4	84.5
5 Yr. Avg. (RRG)	**2.4**	**3.2**	**4.4**	**16.1**	**18.2**	**24.8**	**4.7**	**5.3**	**7.2**	**68.3**	**27.1**	**84.0**
5 Yr. Avg. (CIC)	**2.5**	**3.4**	**3.9**	**24.2**	**24.9**	**28.6**	**5.0**	**5.2**	**5.9**	**64.3**	**19.1**	**76.5**
5 Yr. Avg. (CCC)	**3.7**	**4.0**	**4.2**	**10.6**	**9.9**	**10.5**	**8.6**	**8.0**	**8.5**	**70.7**	**29.9**	**88.7**

RCG = Realized capital gains.
Source: BESTLINK

Underwriting profitability for this group generally weakened over the five years ending in 2020, as reflected primarily in higher loss and LAE ratios from higher accident year loss picks owing to soft market pricing. The 2017 accident year was unusually strong, benefiting from 26 percentage points of favorable calendar year development, largely in MPL. Results through 2014 benefited consistently from 15 to 25 percentage points of favorable calendar year reserve development, resulting in loss & LAE ratios in the high 50s. Since then, what we called the new normal for pricing in these lines has continued, reflecting a soft market that is driving slightly higher loss picks, with less favorable development for loss & LAE ratios, generally in the upper 60s, but breaching 70 in both 2019 and 2020.

RRGs are included in our captive segment, as premium and risks come from a unified group of like-minded policyholders that desires to cover similar risks (e.g. similar lines of business) and share losses. For an RRG, all members must be insured by the RRG and, conversely, the RRG must insure all the members. RRGs are formed by sponsors, business owners, or professional groups and are beneficially formed when groups in similar business lines with similar risk appetites may want to go to the reinsurance market in a stronger position, as a larger and more diverse entity than any individual member could represent.

RRGs share attributes with captives but are often accountable to more than one stakeholder and are more sensitive to pricing and competitive pressures than are SPCs. They are often viewed as being quasi-captive and quasi-mutual. They endeavor to have actuarially required premium to support conservative loss estimates for expected losses while building aggregate capital to support growth (i.e., the addition of new member insureds or expansion of existing policyholder risks) and to provide coverage for unexpected low frequency, high-severity loss events. To the extent that unexpected losses can be avoided and capital can be grown, portions of that capital may be returned to the RRG members in the form of policyholder dividends. Policyholder dividends enable the RRGs to reward or rehabilitate members whose loss experience is a positive or negative outlier to the group's underwriting standards. Additionally, dividends have been traditionally used as both a retention instrument and a recruiting tool. That said, RRGs are not driven by generating profits or growth, but by seeking the most cost-effective ways to insure and reinsure their members' risks.

RRG formations rise during hard markets or when established sponsors pursue an efficient business strategy for a particular, often troubled, line of business, under the auspices of a single domicile/regulator. For example, MPL RRGs proliferated during the hard markets of the early 2000s, when physicians and small practices had found it difficult to obtain affordable MPL coverage. In the past few years, AM Best has assigned a number of ratings to new RRGs formed by well-rated sponsors. In a sponsored RRG, the sponsor reinsures the business of the new RRG. The structure provides established sponsors with the ability to write non-admitted coverage in line with risk appetite and tolerances beyond the sponsor's markets, to increase volume and broaden their footprint.

Given the soft markets of the past few years, RRG formations slowed precipitously, as potential members/policyholders were generally able to buy insurance at cost-effective prices. Sponsored RRGs, however, are still being formed strategically or opportunistically to help companies improve their business profiles as they move into new markets. As we reported in *Market Segment Outlook: US Medical Professional Liability* (March 19, 2021), there remains excess capital in the MPL segment despite the ongoing pressures of decreased demand, social inflation driving up loss costs, and rate adequacy concerns. This helps MPL insurers improve market share through M&A or joint ventures, or create or sponsor ART vehicles or RRGs to tailor their coverages to their specific business risks. These vehicles can provide access to different types of policyholders and can facilitate geographic expansion. RRGs and captives also offer participants opportunities to service high-severity risks that may fall outside their core risk appetites. Rate flexibility is the key reason that the use of ART vehicles will likely continue to grow over the near term, especially given the low failure rate attributed to established MPL RRGs. New formations may have less flexibility, however, as they have not banked the excess reserves that established RRGs have harvested into capital.

Ongoing price firming in the commercial transportation sector has also given rise to captive formations. However, social inflation and nuclear verdicts, backed in many cases by third-party litigation funding, continues to drive up loss costs. This has impacted both the frequency and severity of claims, as the commercial auto line has seen spikes in the amount of claims being filed to cover plaintiff's attorney fees and larger amounts of compensatory awards handed out by juries. RRGs provide a great opportunity for smaller enterprises that are frequently closer to their risks, as policyholders would have a much more difficult time obtaining or affording insurance. In these cases, they have created modest-sized platforms, with relatively small retentions, banding together to aggregate capital and agreeing on policies, procedures, risk appetites, and underwriting standards in a loss-sharing arrangement. This process is often facilitated by third-party captive managers who have extensive experience establishing a common risk management framework and risk tolerances on which to base RRG policies and procedures for loss prevention, mitigation, control, and efficient claims resolution.

Even though an RRG is domiciled in a single state under a single regulator, it must register its business plans and undergo reviews by non-domiciliary regulators of the other states in which it intends to write business. This process reflects the pre-emption provision in the LRRA, whereby a non-domiciliary state regulator essentially defers to an RRG's home regulator. Pre-emption has been challenged in several states but upheld in several circuit court decisions, as some states are less willing to accept business they are not regulating directly. They may also view policyholders as not being adequately protected, since the LRRA also pre-empts states from requiring RRGs to participate in insolvency funds that would support impaired insurers. This debate could weigh on formation approvals, given notable failures and impairments of some RRGs in the recent past in commercial auto liability (Spirit Commercial Auto Risk Retention Group, Global Hawk Insurance Company Risk Retention Group) and MPL (Lancet Indemnity Risk Retention Group).

Effective, Sometimes Lucrative, Outlet for Cyber Risk

Over the past 18 months, AM Best has seen increases in frequency, severity, and sophistication of cyber attacks and they have become a key concern for traditional commercial insurers. Claims from cyber events are escalating significantly, causing the commercial market to reevaluate risk appetites and tolerances, underwriting practices, and profitability for the line, and even modifying policy language to exclude certain events, most notably, ransomware.

Captive insurance companies can provide an alternative to the commercial market for coverage depending on a parent's view of cyber risk, its vulnerabilities, and how cyber ranks in the organization's ERM tolerances and risk appetite. Depending on where cyber risk falls in the risk catalogue, insurance provided by captives can be tailored to meet these needs.

While AM Best believes any company operating 'on the grid' has a certain degree of cyber risk, government agencies, healthcare organizations, financial institutions, and others on the forefront of technological innovation clearly have more at risk than other enterprises.

With COVID-19, most businesses have more cyber vulnerabilities than pre-pandemic due to the extensive and extended remote work-from-home environment that nearly all companies adopted in early 2020. On a positive note, the suddenness of the work-from-home edicts may have accelerated the adoption of new and improved cyber security technology that otherwise would have been deferred.

Once companies determine the type and level of cyber risk they are exposed to, feasibility studies can be conducted to evaluate their options. Clearly, some companies' infrastructures and proprietary trade expertise could warrant significant insurance coverage while others may determine they only have moderate exposure to cyber risk. With this information, companies select one or a combination of: approaching the traditional market for certain levels of coverage, using the captive to retain a portion of the risk, or looking to the reinsurance market to lay off the risk.

As captive insurers write cyber coverage, they need to balance coverage types and levels that make sense, are supported by sufficient capital, are adequately priced, and are clearly defined. When implementing and managing the risk, captives should also interact regularly with any consultants or other key players they may have used and include legal/regulatory considerations. A good practice is to work closely with commercial insurers on their cyber programs and interact with regulators to gain insight on what may be required in the near future. Captives can also collaborate with fronting and reinsurance partners to work on the underwriting for cyber policies. Captive insurers should continue to demonstrate due diligence on cyber security and create their own cyber security governance framework containing a comprehensive risk management process, security awareness programs, and security policies and controls.

We have learned through various headline breaches and claims that the economic loss due to a massive cyber attack could amount to many billions of dollars and the amount of cyber exposure in an insurer's insurance portfolios could be estimated at billions of dollars. Captive risk managers know their risks and exposures and are willing to take such exposures in order to benefit and provide financial efficiencies to their parents. While captives are not a dumping ground for uninsurable or undesirable risk, a combination of the captive insurance, commercial market coverage, and self-insurance by the owner is considered a prudent strategy to avoid potentially disastrous outcomes.

Key Regulatory/Legislative Issues

Captives are periodically subject to legislative and regulatory change when different federal or state administrations take office. Pro-business administrations foster captive-friendly rules that encourage captive formations and coverages of exposures to expand their premium tax bases and, therefore, revenues, at existing tax rates. Pro-consumer administrations seek to ensure business enterprises do not get unfair tax or other commercial advantages that may not be available to consumers or voting taxpayers. We routinely see both as we have in the past few years with the consternation over 831(b) captives under the 2017 Tax Cuts and Jobs Act or the Washington state legislation approved in 2021 to implement new captive insurance fees and taxes.

Vermont continues to refine and improve its leading captive regulatory framework with 2020 marking the 40th anniversary of the passage of the Special Insurer Act of 1981, which created the captive industry in Vermont. In May 2021, Governor Phil Scott signed new legislation strengthening Vermont's captive regulation in a variety of areas. This year's bill, S.88, combined changes to Vermont's insurance and captive insurance statutes in a single bill to help minimize the number of items before the legislature. The bill made several updates to Vermont's captive law, including clarifying the ability for a cell to convert to another type of entity, and simplifying processes around redomestication, mergers, and the filing of organizational documents prior to licensure.

Similarly, Delaware, another leading captive domicile in the US, has broadened legislation in 2021 to increase flexibility for insurance companies. Specifically, statutes have been enacted to enable captives to be classified as registered series (protected cells); clarify provisions regarding insuring parents; and allow for captives to enter dormancy after 12 consecutive months (versus a full calendar year) of inactivity, applicable to companies or cells. Recently, Delaware also authorized issuing conditional Certificates of Authorization for captives upon receiving required capital and surplus, allowing captives to conduct business while the department reviews its license application materials.

As mentioned above, Governor Jay Inslee signed a bill into law in May 2021, providing a framework for captive insurers doing business in Washington state. The bill requires that captives operating in Washington state: (1) register with the insurance commissioner's office, (2) pay a registration fee of $2,500, and (3) pay an annual 2% premium tax on insurance by March 1 every year, starting in 2022. The new law requires captive insurance companies licensed elsewhere but doing business in Washington to pay the 2% premium tax coverage they provided on their exposures in the state going back to January 1, 2011. Notably, the terms are for registration to conduct business in Washington as the bill does not authorize licensing of captives in the state. Nonetheless, according to an independent study commissioned by the Washington State Office of Insurance Commissioner and Washington Department of Revenue before enactment, estimated that revenue generated would be $2.5 million per year and that, under the legislation, captives would come to owe more than $29 million in past premium taxes.

The Connecticut House of Representatives passed HB 6646, related to crumbling concrete foundations. The bill would eliminate the termination date of Crumbling Foundations Solutions Indemnity (CFSI), the captive insurance company established pursuant to Connecticut law. If enacted, it would authorize the Connecticut Housing Finance Authority to make loans to CFSI. In addition, it would require CFSI to submit a report concerning the damage caused by the presence of pyrrhotite to the concrete foundations of nonresidential buildings in the state.

Federally, the IRS continues to scrutinize micro-captives, as it believes that these companies have the potential for tax avoidance and evasion, because captives who make an election under Section 831(b) are taxed only on investment income if their written premium is at or below a certain amount, which is $2.2 million for tax year 2020. The IRS intends to both continue to conduct audits of micro-captive insurance transactions and to shine a spotlight on micro-captives through press releases. The IRS activities have reportedly had the effect of slowing the number of new micro-captives being licensed; however, many of these captives will continue to exist and operate as insurance companies. Given their awareness of IRS activity, ensuring that elements such as risk transfer, risk distribution, and arm's length pricing are in place is highly prudent for not only micro-captives, but for captives of all sizes.

ESG Has Become a More Prominent Ratings Consideration

Captives represent companies/members involved in a wide variety of industries and professional practices. Our rated US-domiciled single parent captives represent a disparate number of industries ranging from auto manufacturers to pharmaceutical to banking. Group captives and RRGs run the gamut from soil engineers to physicians to auto warranty writers. Regardless of the sector or the professions they serve, all of them will need to find their way in adopting and adhering to commonly accepted ESG principles.

For single parent captives, most are part of larger publicly traded parent organizations governed and regulated by the SEC. While the SEC has yet to put out guidance on ESG, many publicly traded companies have already been addressing this through disclosure documents, as formal adoption by the SEC appears almost certain. In March 2021, Acting SEC Chair Allison Lee announced the opening of a comment period regarding climate change disclosures. These submissions are likely to be used in developing future guidance and proposals on ESG issues, which is also supported by the Biden administration. The SEC has stated publicly that it will play a role in supporting the Biden initiatives where appropriate – a position that is likely to push the long-debated, mandatory ESG disclosure requirements toward the finish line. As noted earlier, many publicly traded companies are already responding pre-regulation in varying forms, as it is an indication of good corporate citizenship and the awareness of the many public ESG issues.

Since most privately held US-based, single parent captives and group captives come under the auspices of the NAIC, all eyes are on the Commissioners to see what "next steps" are underway. To date, the NAIC's "position" on ESG has been neutral but initial steps seem to indicate there's some interest in the environmental and social factors, resulting in the formation of the Climate and Resiliency Task Force (which includes five separate work streams) and a Special Committee on Race and Insurance (also with five separate work streams). Regardless of formal guidance, ESG is a significant issue gaining momentum in the US and insurers, captive or traditional, will be included.

Since April 2020, AM Best has been identifying those rating actions that involve ESG-related factors. These actions are identified in our Rating Disclosure Forms and are included in the press releases for those rating actions where ESG factors played a key role. From April 2020 to March 2021, 13% of AM Best's global rating actions were driven primarily by ESG factors. The most commonly cited ones to date for all of our worldwide ratings have been related either to governance or environmental factors as it related to exposure to natural catastrophes. Specifically, governance and environmental factors consisted of 69% and 31% of positive rating actions and 43% and 35% of negative rating actions. With regard to captives, ESG rating factors were not considered to have influenced any rating action on captives, both in the US and in all the other global domiciles. This can be attributed to a function of the enterprise-wide risk management strengths of the captive owners and sponsors. Many of the single parent owners are household names with significant resources dedicated toward ESG. Group captives and RRGs are member-driven with narrower profiles and size/scope that may deter some of the issues. Additionally, natural catastrophe is generally not a significant risk for the rated captives where the lines of business tip toward general liability, professional liability, workers compensation, and commercial multiple peril.

The nature of the organization's business has put some captive owners under more scrutiny than others. Each owner has its own particular set of circumstances depending on its function. Because of the heightened concern for environmental issues, the oil and gas and energy sectors are under the microscope. Many of the environmental headlines this year have been specifically aimed at this sector. In May 2021, Chevron Corp. was challenged by environmentally active shareholders pushing for lower emissions. Around the same time, a Dutch court ordered Royal Dutch Shell plc to reduce emissions at a faster pace. Both Chevron and Shell have rated captives. ESG investing is a significant issue in this space as momentum has risen behind efforts to promote renewable energy, sustainability, and the transition of energy sources. ESG pressures are being felt throughout the oil and gas sector, with the upstream segment scrutinized on environmental impact and the midstream for governance and social impact.

Globally AM Best rates 23 single parent and group captives that are in the energy space, primarily oil companies and electricity providers. Of these, 7 are located in US domiciles.

While AM Best does not rate the parent companies of the rated captives, the financial capabilities of the owners are certainly closely monitored. In Best's Credit Rating Methodology (BCRM), credit for the wherewithal of the parent is given in either the rating's balance sheet strength evaluation or in provided lift or drag to the published rating. A troubled parent could hinder the captive's performance if cost-cutting measures were to result in less rigorous risk management and, ultimately, weaker operating results at the captive.

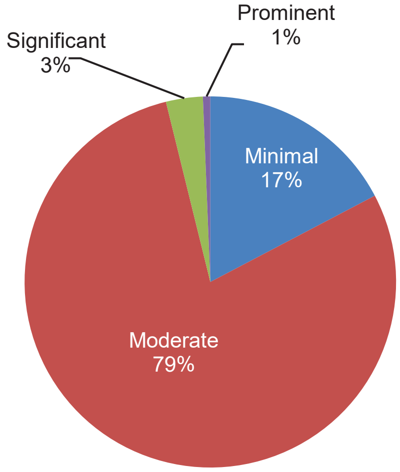
ESG has an indirect effect on captives regarding their investments. Many make loans of working capital to the parent company for a number or reasons, including enhanced returns as part of the corporate investment program. We expect that these domiciled approved "loan-backs" are documented properly with an arms-length loan agreement. A change in a captive parent's operations, notably in an effort to manage transition risk in certain industries, can have a knock-on effect on their insurance needs. Ultimately, this would require a captive to adapt accordingly.

Captives Score Well on Innovation

AM Best's *Scoring and Assessing Innovation*, introduced on March 5, 2020, details our two-pronged approach to scoring innovation and its impact on a company's business profile. We define innovation as a multi-stage process that transforms ideas into new or significantly improved products, processes, services, and business models that have measurable positive impact over time and enable an organization to stay relevant and successful and can be organically grown or adopted from external sources. AM Best views the establishment of captives as alternative risk transfer mechanisms as a corporate innovation in and of itself. AM Best, however, does not expect significant continuous innovation within the captives.

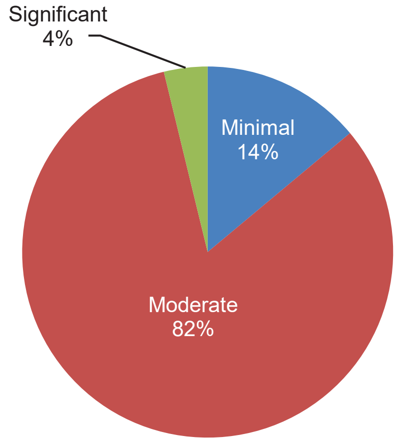
In assessing each company's innovation profile, scores were based on analysts' discussions and interactions with the management teams of the rated companies. Each company has been evaluated with regard to the company leadership's view of innovation; its culture, resources, and process and structure; as well as the impact of innovation and enterprise transformation on results. The total innovation score—the input plus the output scores—translates into five assessment categories: Leader, Prominent, Significant, Moderate, and Minimal. **Exhibits 14** to **17** show the distribution of innovation assessments for the universe of AM Best rated captives.

Exhibit 14
AM Best – Innovation Scores – All Captives



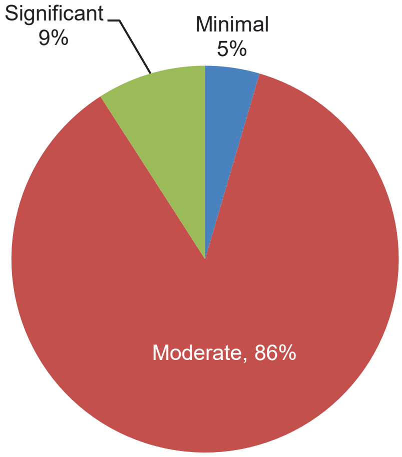
Source: BESTLINK

Exhibit 15
AM Best – Innovation Scores – US Captives



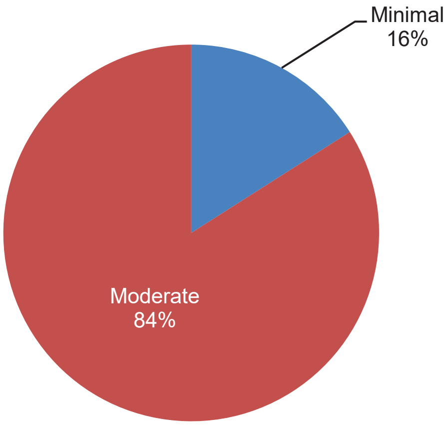
Source: BESTLINK

Exhibit 16
AM Best – Innovation Scores – SPCs



Source: BESTLINK

Exhibit 17
AM Best – Innovation Scores – RRGs



Source: BESTLINK

December 17, 2020

Rated Bermuda, Cayman Islands, and Barbados Captives Continue to Outperform Peers

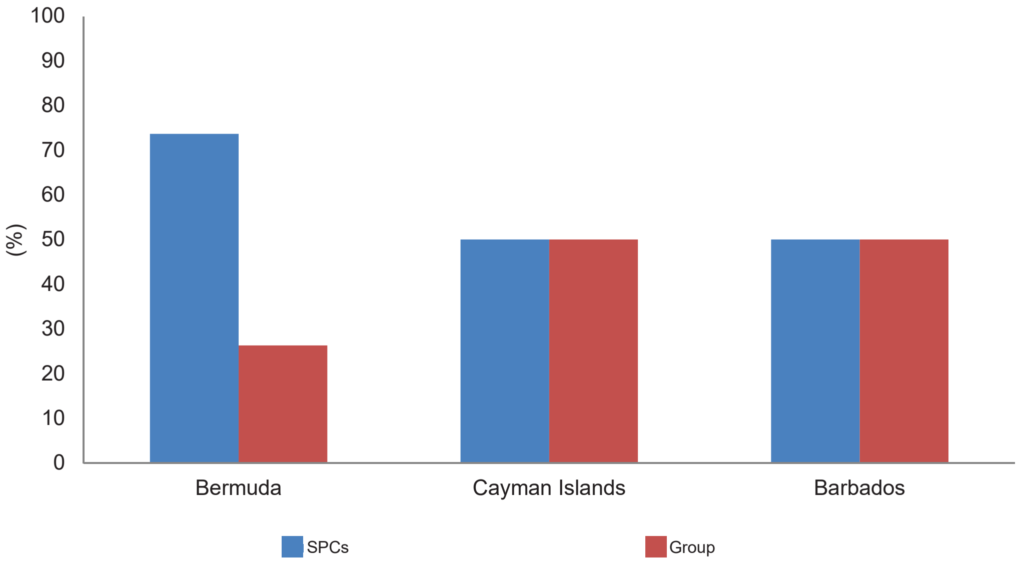
2019 underwriting results dipped, but long-term profitability remains favorable

The captives rated by AM Best continue to outperform the US commercial casualty composite on underwriting and operating profitability. Of the approximately 200 captives AM Best rates worldwide, almost 30 are based in Bermuda, the Cayman Islands, and Barbados (BCIB). **Exhibit 1** shows the rated BCIB captives by type, whether single-parent or group. These long-standing domiciles have global reputations that have allowed them to maintain and grow their captives. They are the first, second, and seventh largest global captive domiciles, which number nearly 1,700. Although off-shore tax benefits for US owners/sponsors diminished somewhat following enactment of the Tax Cuts and Jobs Act (TCJA) of 2017, captives are not established for tax savings purposes, and these jurisdictions continue to grow. The benefits and consistency of local captive management and a captive-friendly regulatory environment have enabled Bermuda, the Cayman Islands, and Barbados to maintain and even grow their foothold in the captive market.

About two thirds of the rated BCIB captives are owned by US-based businesses or, in the case of group captives, are aligned with US groups and associations. The remaining rated captives are mostly single-parent captives sponsored by a broad group of owners in Japan, Taiwan, Colombia, Saudi Arabia, and Europe. The largest captive managers and advisors have a broad global reach, providing services that go beyond the domicile and location of owner/sponsor. This has enabled both strong retention as well as growth in the number of captives regulated in the BCIB as other domiciles have popped up over the last 20 years.

Exhibit 1

AM Best Rated Captives – Percentage of Single-Parent and Group Captives



Source: AM Best data and research

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2020-215

Captive Insurance Segment Continues to Grow

The number of captive jurisdictions continues to expand, even as many of the long-standing captive domiciles look to modify their regulations to foster growth in this ever-growing market, which is still considered an “alternative.” But captives are part of the vernacular now—“alternative market” is an antiquated misnomer. There are now more captive insurance companies globally than traditional insurers—estimated at more than 7,000 captives, domiciled in more than 70 jurisdictions. Corporate risk managers from almost all of the global Fortune 1000 companies, as well as many smaller public and private companies, routinely use them. Global domiciles continue to solicit captives, and global insurers and reinsurers alike have become intimately familiar with them. Even the leading global brokers have gotten deeper in the mix, with the formation of protected cell captives. The captive market has an abundance of intellectual capital and has some of the more creative thinkers in terms of risk-taking and innovation, and finding creative, responsive solutions to risk.

BCIB Captive Composite Results Versus US Commercial Casualty

The operating results of the BCIB composite have been relatively consistent year over year, similarly to the rated captives domiciled in the US. Both groups have reported results that consistently outpace those of the traditional US commercial casualty insurers. (The data in this report includes reported financials as of fiscal/calendar year 2019; year-end 2020 results have yet to be reported.)

The BCIB composite’s underwriting results dipped in 2019, reaching a five-year high loss and loss adjustment ratio (LAE) ratio of 61.6, versus 55.3 in 2018. This drop was due largely to higher-than-expected fire and property losses, predominantly from the US, as well as larger-than-average losses from general liability.

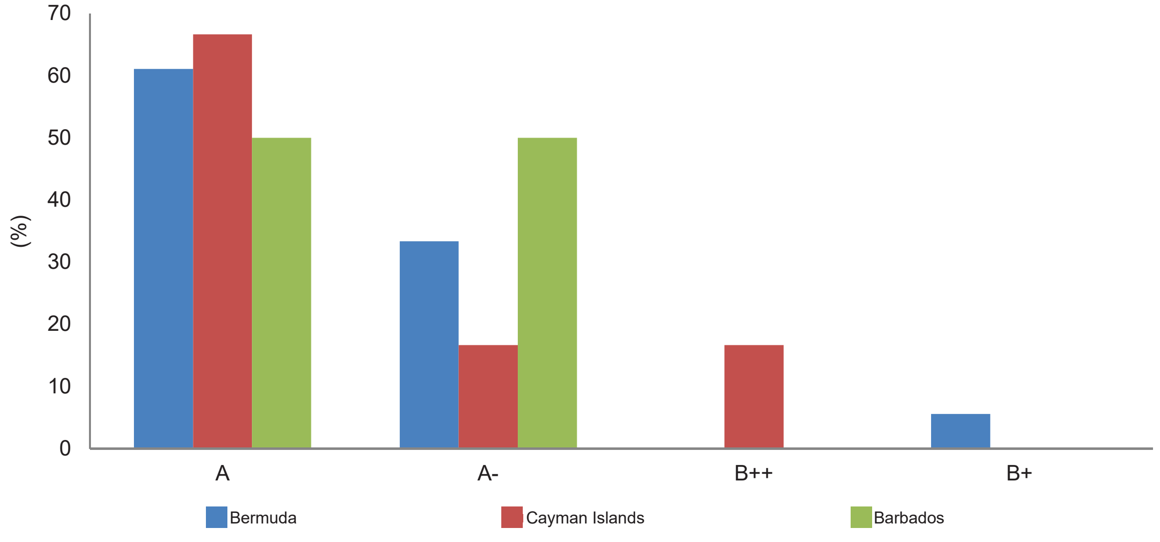
Despite lower than normal underwriting results in 2019, the segment’s longer-term profitability is favorable when compared to that of its US commercial casualty peers. Since captives are usually formed to ensure insurance availability and consistency in costs via level premiums year over year (in addition to their primary function of risk financing), operating profitability is a bonus for captives and their captive owners. The lack of public data makes it impossible to comment if the experience of the much larger base of unrated captives is comparable. The operating fundamentals of captives depend on the risk financing needs of their owners—if the growth in the number of captives in the BCIB domiciles is an apt indicator, they continue to serve the particular needs of their owners.

AM Best’s BCIB Ratings

AM Best’s ratings on the BCIB captives remain largely in the A to A- range (**Exhibit 2**), reflecting the companies’ generally robust balance sheets, their integrated risk management practices, managements’ in-depth knowledge of the risks insured, and the inherent advantages of being owned by member insureds or by larger organizations with extensive resources and financial flexibility. The companies’ traditionally solid operating performance and supportive risk management capabilities are also consistent with ratings. The ratings distribution is similar to that of all of the global captive ratings, which tip to the higher rating levels. Captive owner/sponsors deal with third-party users as well as AM Best and position themselves accordingly with regard to their capitalization and operating fundamentals.

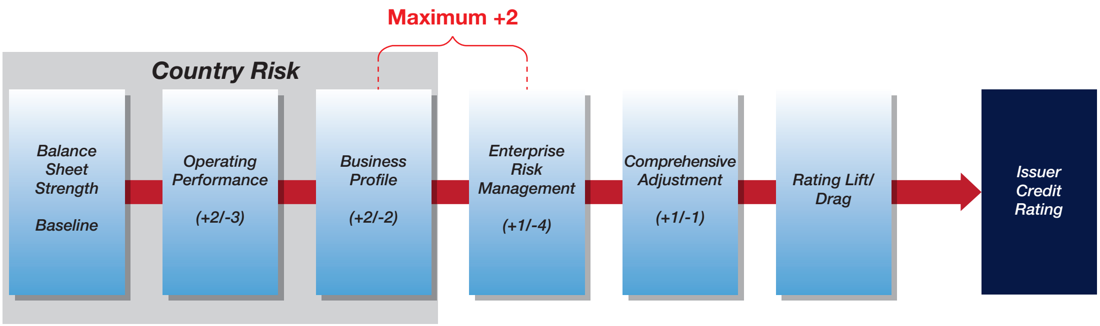
AM Best’s ratings on captives recognize the unique nature of these structures and incorporate how these companies fit within an organization (single-parent) or among their member insureds

Exhibit 2
AM Best Ratings on Bermuda, Cayman Islands, and Barbados Captives



Source: AM Best data and research

Exhibit 3
AM Best's Credit Rating Methodology Building Blocks



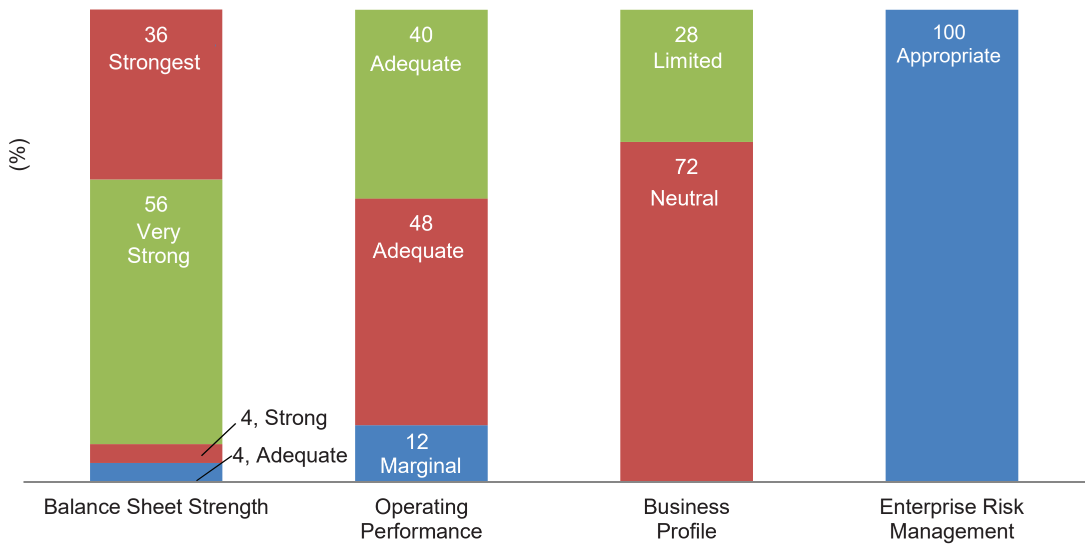
Source: Best's Credit Rating Methodology

(group). For captives, qualitative aspects such as the company's specific purpose, its direct access to the business, any additional financial flexibility afforded by stakeholders, the nature of the business written, and whether management has a clear understanding of the captive's risk management capabilities and risk tolerances are all critical analytical factors.

The building blocks of our rating analysis (**Exhibit 3**) are the same for all rated insurers, although the conclusions drawn from these assessments can differ dramatically from those of third-party commercial insurance companies, owing to the nature of captives and their inherent, specific advantages and limitations. In essence, captives have traits and operating fundamentals that wouldn't carry nearly as much weight as they would if these carriers were aligned with a traditional company.

Exhibit 4 shows the four primary building block assessments—balance sheet strength, operating performance, business profile, and enterprise risk management (ERM)—of the BCIB captives. These results have not changed materially from last year. The balance sheets

Exhibit 4
AM Best Building Block Assessments – Rated Bermuda, Cayman Islands, and Barbados Captives



Source: AM Best data and research

of more than 90% of the rated captives are assessed at the "Very Strong" to "Strongest" levels. This assessment gives no credit for implicit parental support, which is considered in rating enhancement via parental lift (or drag). Therefore, the balance sheet strength assessment reflects a stand-alone view of just how well these companies have been capitalized relative to their individual business risks.

The BCIB captives' operating performance for the most part is better than the overall industry's. The operating performance of 40% of the BCIB captives is assessed at "Strong," with only a relatively small percentage, 12%, assessed at "Marginal."

The business profiles of 72% of BCIB captives are assessed as "Neutral." This assessment takes into account not just a captive's line of business and geographic diversity, but also the organization's loss control practices, safety, risk management, risk awareness, and its competitive advantages, among other factors.

Finally, all of the BCIB captives have been assessed as having "Appropriate" ERM. This assessment takes into account not only the captive's risk framework and its risk profile relative to its capabilities, but also how well the captive is integrated into the ERM framework of its parent or owner—the source of the risk for which it is providing coverage. The single-parent captives (SPCs) in this composite, as well as virtually all of the rated global SPCs, serve as integral parts of the overall risk management framework.

Ratings Lift/Drag

The final step in the rating process is a determination of ratings lift/drag. In the case of captives, a review of their non-insurance parents is performed, outside of the four building blocks. The impact of the non-insurance ultimate parent can result in rating lift or drag on the captive's stand-alone assessment. In these instances, the ultimate parent, which may be in the energy, automotive, or manufacturing sectors, may be viewed as having a positive, neutral, or negative impact on the rating, expressed through rating lift or drag. This evaluation depends not only on the creditworthiness of the parent, but also on the likelihood of support and the form that support may take. Conversely, a non-insurance parent might also be viewed as a financial weak parent, which could lend itself to concerns about the possibility that a call by the parent on the captive's capital might expose the captive to material risk. This would be expressed in rating drag.

The analysis of a rated insurer's non-insurance owner includes an assessment of publicly available credit measures, market-based credit measures such as credit default swap (CDS) prices (spreads) where available, and independent financial analysis. The analytical team can use any financial and non-financial information on a non-insurance owner that is available in the public domain, such as news reports and stock reports and recommendations, which can provide valuable insight. The weight of the approaches used to generate an assessment of the non-insurance owner is determined by the rating analyst, who may consider the parent's leverage and the ability to service this leverage from sources other than its insurance operations. A rating analyst's conclusion that the insurance operations could be called upon to service the obligations of the parent could have a negative bearing on the assessment of the lead rating unit, potentially resulting in drag.

Publicly available credit assessments of non-insurance owners include the credit ratings assigned to the company or group by other credit rating agencies (CRAs) with expertise in that particular industry. A major CRA's credit analysis incorporates quantitative and qualitative information from public and non-public sources, in addition to the proprietary expertise the CRA derives from the processes and people involved in assigning a rating. For a non-insurance ultimate parent, AM Best would use a major CRA's publicly available credit ratings to form an opinion of the parent's creditworthiness. The gap between the parent's CRA rating and the relative strength or weakness of the insurance operations will also factor into the determination of lift/drag. Only three of the BCIB SPCs receive rating lift; none receive drag. The rated SPCs often have to meet the financial size requirements of third-party users and frequently have high gross and net limits written. As a result, the owners support balance sheets explicitly through contributions and retention of earnings. As a result, many of the SPCs have balance sheet building block assessments as "Strongest" or "Very Strong," which lowers the number that would receive lift.

Performance and Results Are Notably Consistent

Exhibit 5 illustrates the ongoing profitability of the BCIB captives' operating performance. The addition of new risks from the hardening commercial lines market and accompanying

Exhibit 5

BCIB Composite – Financial Indicators, 2015-2019

(USD millions)

	Net Premiums Earned	% Chg	Pretax Operating Income/ Loss	% Chg	Net Income/ Loss	% Chg	Total Assets	% Chg	Loss & LAE Reserves	% Chg	Year-End Surplus	% Chg
2015	3,252		933		864		19,016		6,450		8,226	
2016	3,140	-3.4	869	-6.8	785	-9.2	20,341	7.0	6,721	4.2	8,933	8.6
2017	3,320	5.7	1,093	25.7	1,085	38.2	21,880	7.6	7,027	4.6	10,041	12.4
2018	3,635	9.5	952	-12.9	894	-17.6	23,370	6.8	7,712	9.8	10,442	4.0
2019	3,996	9.9	1,391	46.2	1,297	45.0	25,385	8.6	8,205	6.4	11,534	10.5

Source: AM Best data and research

economic growth has yielded steady premium growth the past three years. Net premiums earned rose nearly 10% in both 2018 and 2019, with a comparable increase likely when year-end 2020 results are released. However, some of this growth is likely to be counterbalanced by higher-than-expect reinsurance costs in 2020.

The rebound in the BCIB captives' pretax operating income in 2019 to the group's highest level ever recorded was driven by the improvement in the equity markets early in 2019, which bolstered both realized and unrealized capital gains. In addition, net earned premium increased by nearly 10% to drive the higher income total. Subsequently, the return on revenue rose to 32.5% in 2019, from 24.6% in 2018, resulting in a five-year average of 28.4%. These exceptionally high returns are indicative of the large amount of invested assets for the group—up 12.9% from 2018.

Underwriting results declined somewhat but were still better than those of the US commercial casualty composite. As stated, the combined ratio for 2019 deteriorated to 91.8. However, the five-year (2015-2019) average combined ratio of 85.0 is still significantly below the near breakeven combined ratio posted by the US commercial casualty peers (**Exhibit 6**). Similarly, the five-year average operating ratio was 67.8, versus 87.0 for the commercial casualty industry, owing to strong investment income. Additionally, the five-year average investment ratio (NII/NPE) of 13 was on par with the commercial industry's 13.4. Despite some year-over-year variability in underwriting results, five-year average results compare very favorably, particularly when considering return on revenue.

The BCIB captives also posted a strong, double-digit return on equity (ROE), 11.8%, rebounding from depressed investment yields in 2018. Favorable prior-year reserve releases and generally limited exposure (short of a few shock losses) to catastrophe events were the two key contributors to solid margins and strong ROE in 2019, as well as the last five years.

The captive group's overall capital levels are sound and more than supportive of the risks underwritten, with capital continuing to grow and remaining strong even after dividend payments (**Exhibit 7**). Captives are not pressured by stakeholders for a return on equity or revenue growth in the way that traditional P/C insurers are pressured. During 2015-2019, even after paying out over $1.4 billion in dividends, the BCIB captives added more than $2.7 billion to their capital and surplus, which translates into nearly $4.2 billion in savings if commercial insurers had been used instead of captive vehicles.

Exhibit 6

BCIB Composite vs Commercial Casualty Composite – Profitability Analysis

	Loss & LAE	Underwriting Expense	Combined Ratio	Investment Ratio	Return on Revenue	Return on Equity
2015	54.7	23.3	77.9	10.8	26.6	21.0
2016	59.1	26.1	85.2	12.6	25.0	9.2
2017	55.3	29.6	85.0	13.6	32.7	11.4
2018	55.3	29.7	84.9	15.3	24.6	8.7
2019	61.6	30.2	91.8	14.3	32.5	11.8
5 Yr. Avg. (BCIB)	**57.2**	**27.8**	**85.0**	**13.3**	**28.3**	**12.4**
5 Yr. Avg. (CCC)	**69.8**	**29.2**	**100.0**	**87.0**	**12.3**	**8.4**

Note: The commercial casualty composite (CCC) is composed of all statutory filers; BCIB figures are based on GAAP and IFRS. Despite nuances in calculations, we believe the comparison is consistent and applicable.
Source: AM Best data and research

COVID-19 Could Lead to More Growth in Captive Utilization and in Formations

Exhibit 7
AM Best Rated Captives – Total Savings, 2015-2019
(USD millions)

	C&S 2015	C&S 2019	C&S Increase	Dividends	C&S Total
All US Rated Captives	21,050	24,801	3,751	4,420	8,171
US RRGs	2,293	2,739	446	374	820
US SPCs	8,730	10,447	1,717	1,274	2,991
BCIB	8,228	10,968	2,741	1,433	4,174

C&S = Capital & Surplus; RRGs = Risk Retention Groups; SPCs = Single Parent Captives
Source: AM Best data and research

It's far too soon to see whether the captive market has responded to the COVID-19 crisis with new coverages or premiums written. As in the past, captive owners may look to judiciously add on more lines, and new captive/group captives could form as the impact on availability becomes more defined. Due to their concentration in US businesses, captives' response will also depend on whether the US passes a federal pandemic program and what the terms and composition of any such program would be—that it, whether it would be similar to the national flood program where insurance is provided by the US government or a joint public/private program like terrorism and crop.

The pandemic will continue to impact the world economy for some time—as well as the global commercial insurance market, as it endeavors to fill market voids for existing classes as well as for new risks emerging from the crisis. We expect the rated captives to take their typically measured—conservative—approach to add any new exposures.

What has led to the increase in the growth in the BCIB earned premiums in recent years has been the firming of commercial lines in the US. According to a recent Marsh Global Insurance Market Index report, commercial insurance rates rose globally an average 19%, the largest increase in the eight years of the index. According to the quarterly Commercial Property/Casualty Market Index from the CIAB, rate increases ranged from mid-range to significant rate increases for all account sizes and all commercial lines at 11.7. Growth in existing lines and new coverages added before COVID-19 will continue to add to written premium when the 2020 results are compiled.

Innovation Remains Paramount

Captives have two primary reasons for wanting to innovate: to better address their member owners' needs and to realize operational efficiencies. Captives are no longer formed solely to protect against the lack of available capacity or peaks in the market cycle, but have become a solution for companies interested in flexibility, risk financing, and more hands-on risk management for enhanced safety, loss control, and loss prevention. These companies have essentially taken more ownership of their risks, making captives increasingly integral to corporations around the globe. Gaining efficiencies and improving margins through loss prevention and lower (re)insurance costs have played important roles

Emerging and disruptive technologies are affecting all kinds of industries in a multitude of ways, through the use of artificial intelligence, predictive analytics, data warehousing, and data mining. Captives, because of their expertise, the homogeneity of the risks they insure, and their close proximity to those risks, tend to be more nimble than the insurance industry overall and have generally been able to adapt and improve outcomes faster than the standard market. Captives also benefit from rate and form flexibility and are often able to develop and adopt new coverage options as they work with their reinsurance partners on pricing and coverage terms. Historically, captives have achieved less success with systems and technology-led innovations, but some are now taking advantage of the developments in digitization that make it easier and more

Cayman Islands Off the Black List

In October 2020, the European Council announced that it had removed the Cayman Islands from the EU's list of non-cooperative jurisdictions for tax purposes. According to the Cayman government, it was added to the list because of a delay in enacting legislation on the oversight of "collective investment vehicles." Subsequently enacted legislation brought the subject funds under the jurisdiction of the Cayman Islands Monetary Authority. This is a positive for Cayman captives and all financial services domiciled there, but inclusion on the list has not dampened the growth in captives. Thirty-three captives were added in Cayman in 2018 and again in 2019, with continued growth expected for 2020.

Barbados Deemed "Partially Compliant"

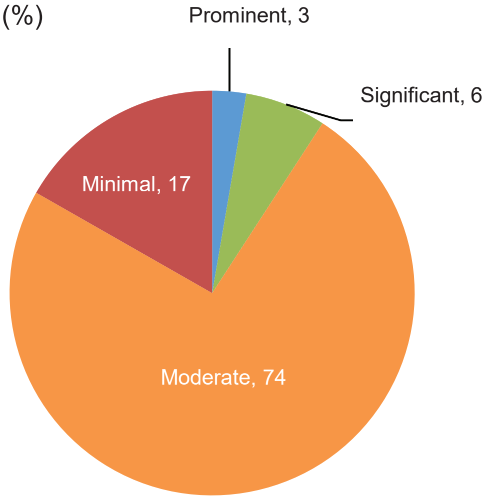
Also in October, Barbados was added to the European list following peer review reports published by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Barbados' rating was downgraded to "partially compliant" with the international standard on transparency and exchange of information on request. The Barbadian government responded that it was being penalized for being partially compliant in only three of the ten essential elements of the OECD standard: availability of ownership and identity information; availability of accounting information; and the quality and timeliness of its responses to requests from overseas tax authorities. (The country was evaluated as being compliant with the other seven elements.) Barbadian authorities have protested the decision and have asked for a Supplementary Review, but the ranking though will remain in effect until the EU Council's next meeting, in February 2021.

Despite the ranking, Barbados continues to add to the number of captives domiciled there—18 in 2019 and more expected in 2020. The growth in captives in both the Caymans and Barbados is likely due to the preponderance of North America captives, which aren't influenced by the EU list and the flexibility and evolution of the BCIB captive regulators.

cost-effective to write third-party business to strengthen their relationships with key partners. They are also gaining some diversification advantages. Big data and actuarial developments are supporting captives with the underwriting of new products, whether for the benefit of their parents or third parties.

AM Best released its criteria procedure, **Scoring and Assessing Innovation**, in March 2020. A full rating cycle of applying the criteria to the captives is still a few months away, but preliminary innovation scores fall mostly in the moderate category (**Exhibit 8**). Standard commercial insurers tend to score higher, with more in the Prominent category, as these companies are competing for third-party business and need to find innovative ways to retain existing customers and attract new ones. Captive companies are generally focused on innovation efforts that help lower insurance costs and losses through risk management, loss control, and safety protocols. These efforts are focused mainly on loss identification, loss prevention, loss mitigation, and risk management.

Exhibit 8
AM Best Rated Captives – Innovation Scores
(%)



Source: AM Best data and research

November 30, 2020

Europe's Captive Segment Poised for Growth Amid Hardening Insurance Conditions

Captives are poised to benefit from the response of the wider insurance industry to the COVID-19 pandemic

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Principal Takeaways

- Commercial insurance rate increases are expected to drive an uptick in new captive formations and greater utilisation of existing captives
- Captives provide their owners with the flexibility to navigate the insurance cycle and maintain access to cover on an ongoing basis
- AM Best-rated European captives have been resilient to the COVID-19 shock, generally maintaining stable ratings fundamentals during 2020
- Captives' innovation initiatives are usually driven by the needs of their parents
- A captive's approach to ESG is often closely linked with that of its parent organisation

I - Tightening Market Conditions Highlight the Relevance of Captives as a Risk Management Tool

Captives are an important risk management tool for their owners, providing them with the flexibility to navigate the insurance and reinsurance underwriting cycle and maintain access to the risk cover they require on an ongoing basis. In the hard phases of the insurance cycle, captives can offer tailored risk solutions to their parents on lines of business where commercial capacity has contracted, or where cover has become too expensive or even unavailable. Captives also provide owners with access to reinsurance market capacity. A captive can be an efficient vehicle to manage the risks groups are willing to retain relative to the price of cover.

Price increases in the (re)insurance market began to appear as early as 2018 in some segments. The market continued to harden in 2019, and increases have gained significant momentum in 2020, as the industry has reacted to losses resulting from the COVID-19 pandemic. Since the beginning of the year, commercial insurers and reinsurers have commonly reported double-digit percentage increases in rates, and a tightening of terms and conditions. Casualty lines in particular have experienced significant price increases, as insurers have responded to the impact on loss experience of social inflation stemming from increased litigation and so-called "nuclear" verdicts.

Amid tougher renewal discussions, AM Best has observed an uptick in the use of existing captives, as owners seek optimal risk transfer solutions. A number of captives have increased retentions or limits on existing cover, while in some instances they have expanded into new lines of business as their parents have looked at increasing captive utilisation. AM Best also believes that the current market environment could give rise to an increase in the formation of captives, as challenging economic conditions, added to the rising cost of insurance, provide the ideal environment for corporates to look at how they might optimise their risk transfer programmes.

Taken together, these factors are expected to contribute to an expansion of business volumes for the captive industry.

In this context, it is important for captives to ensure they can continue to support their parents' risk management strategy, notably by maintaining relevant underwriting expertise. As utilisation increases, captives also need to maintain appropriate creditworthiness, including sufficient capital levels. This is especially important for reinsurance captives, which use primary insurers to front their owners' risks.

II - Regulatory Tweaks Upcoming in Some European Captive Domiciles

Europe's top three captive domiciles – Guernsey, Luxembourg and the Isle of Man – all saw a reduction in their number of registered captives during 2019, with the number of licences surrendered exceeding the number issued. However, AM Best expects this trend to reverse in 2020 and 2021 as hard market conditions make captives more attractive as a risk retention tool.

The regulatory frameworks in the main European captive domiciles are relatively stable, though some domiciles are undertaking reviews of their regulations while others have agreed changes. For instance, the Isle of Man Financial Services Authority's updated Corporate Governance Code of Practice will apply to all non-life insurers with effect from 30 June, 2021. The updated code contains a number of captive-specific elements:

- Captives must have access to an effective actuarial function capable of evaluating and providing advice on technical provisions, premium and pricing activities and compliance with related statutory and regulatory requirements. However, captives are exempt from the full actuarial function requirements that apply to commercial non-life insurers;
- Unlike commercial non-life insurers, captives are not required to present in writing annual internal audit findings and recommendations to their board;
- Captives are exempt from the fair treatment of policyholder requirements when their policyholders are related parties or insurers to which the captive provides reinsurance;
- Captives can apply a number of exemptions to the Own Risk and Solvency Assessment (ORSA) requirements; as a result, they can apply a minimum forecasting time horizon of less than three years, and elect to provide summary ORSA information to the regulator instead of submitting the full ORSA report.

In addition, for captives domiciled in the EU, the 2020 review of Solvency II is ongoing. One item under review, which will be of particular interest to captives and their owners, is the application of proportionality.

Under Solvency II, the principle of proportionality is applied to ensure that the practices and powers taken by supervisory authorities are proportionate to the nature, scale and complexity of the risk inherent in the business of the insurer or reinsurer. As captives are often small and lightly staffed operations, this principle of proportionality is of particular importance to them in ensuring that the regulatory requirements do not become overly burdensome.

Some argue that captives should be subject to lighter regulation when their only policyholder is their parent organisation, and there was lobbying in favour of the introduction of a two-tier supervisory regime to be considered as part of the 2020 review.

However, the European Insurance and Occupational Pensions Authority (EIOPA) rejected this option in its "Consultation Paper on the Opinion on the 2020 review of Solvency II" (October 2019), stating that it would lead to different levels of protection under Solvency II and create legal uncertainty. The supervisory body also stated that the original decision (as to which supervisory regime an enterprise should be subject to) would be burdensome and monitoring difficult due to the reduced reporting envisioned. Instead, EIOPA vowed to reinforce proportionality across the three pillars of Solvency II.

While EIOPA's rejection of more substantial reform of the application of proportionality under Solvency II will be a disappointment to some captives, AM Best believes that it is beneficial to maintain a unified regulatory framework. Knowing that the full Solvency II regulatory requirements are applied to captives can offer security to various captive stakeholders – be they insurance fronters, legal entities and employee representatives in the parent organisation, or subcontractors and joint venture partners.

III a – Innovation Enables Captives to Remain the Underwriters of Choice of Their Parents

Innovation is becoming increasingly critical to the long-term success of all insurers, and captives are no exception. Well-structured innovation allows companies to develop sustainable competitive advantages and better respond to external challenges such as low investment yields, stagnant growth, and deteriorating expense ratios.

Details of AM Best's approach to scoring an insurer's innovation initiatives and its impact on business profile can be found in its Specialty Criteria Procedure, "Scoring and Assessing Innovation" (March 2020).

AM Best's evaluation of a company's innovation level is based on two elements:

- Innovation inputs – the components of a company's innovation process – which encompasses leadership, culture, resources, and process and structure; and
- Innovation outputs – the impact of the company's innovation efforts – which considers the results of innovation and its level of transformation.

The resulting innovation score is the sum of these two evaluations, which allows AM Best to assign an innovation capability assessment (see **Exhibit 1**).

The distribution of innovation capability assessments for the global population of AM Best-rated captives can be seen in **Exhibit 2**.

Captives are themselves an example of innovation in the insurance space. They were created to provide insurance solutions not readily available in the open market, to develop flexible risk coverage and to improve the risk management and loss prevention capabilities of their parent groups.

Exhibit 1
Translating the Innovation Score

Score	Range
<12	Minimal
12-17	Moderate
18-22	Significant
23-27	Prominent
≥28	Leader

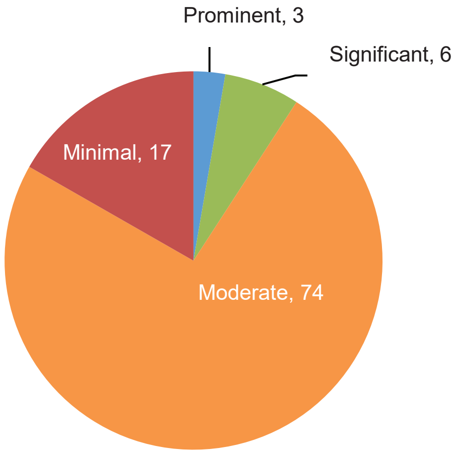
Notes:
AM Best's scores are based on analysts' discussions and interactions with companies.
To be considered a Leader in innovation, companies must demonstrate that their innovation process creates tangible and quantifiable value.
Source: Best's Credit Rating Methodology

The success of this innovation is demonstrated by the endurance of the model and by the continuing importance of captives to their parents. Captives make use of their privileged access to data and proximity to risks to develop customised products that cover the changing needs of their parents.

This proximity to risks also enables captives to explore innovative ways to improve loss prevention, gathering loss information and data on risks that provide captives with significant expertise in prevention measures.

Historically, captives have achieved less success with systems and technology-led innovations. However, some captives are now taking advantage of the developments in digitalisation that make it easier and more cost-effective to write third-party business to strengthen their relationships with key partners. At the same time, they are also gaining some diversification advantages. Big data and actuarial developments are also supporting captives with the underwriting of new products, whether for the benefit of their parents or third parties.

Exhibit 2
AM Best – Innovation Scores – All AM Best-rated Captives
(%)



Note:
This chart originally appeared in AM Best's Market Segment Report, "Commercial Market Dislocation Could Provide New Opportunities for Captives to Fill the Void" (July 2020).
Source: AM Best data and research

III b – A Captive's Approach to ESG is Often Closely Linked With That of its Parent Organisation

Environmental, social and governance (ESG) considerations are rising up the corporate agenda amid increased scrutiny from consumers and regulatory authorities. In Europe, the implementation of the EU Directive 2014/95/EU sets out the disclosure requirements of non-financial and diversity information for large companies. While this directive does not apply directly to captives, an increasing number are considering incorporating ESG factors into their operations.

AM Best notes that a captive's ESG approach is often closely linked with that of its parent organisation. An increasing number of captives' owners have integrated ESG factors in their operations, influencing areas such as corporate governance and investments. This has an indirect effect on captives, with many of them holding a large part of their investments in inter-company loans, with the underlying assets invested by their parents. A change in a captive parent's operations, notably in an effort to manage transition risk in industries such as oil and gas, can have a knock-on effect on their insurance needs. Ultimately, this would require a captive to adapt accordingly.

What might also require captives to adapt are the changing market conditions resulting from a growing number of commercial (re)insurers formally integrating ESG factors in their strategy. A consequence of this might be capacity shortages in some lines of business or sectors, which could create business opportunities for captives in so-called "toxic" industries.

As ESG risks vary dramatically by both industry and line of business, AM Best believes that captives should assess ESG exposures as part of their risk management activities and be able to recognise, measure and address the impact on their business. A failure to do so can present significant risks, be they financial or reputational.

Cyber risk and environmental liability are just some of the new areas of coverage for captives, and as such will require a fresh consideration of ESG factors for operators. In the case of cyber, coverage brings with it a focus on aspects such as social engineering and data security. Captives will need to be conversant with the potential impact of aspects like these on underwriting and investment exposures.

IV – COVID-19: Low Investment Risk and High Capital Buffers Make Captives Resilient to Shocks

AM Best's view that the European captives it rates have strong capital buffers that provide resilience against severe market shocks appears to have been successfully tested following the outbreak of the COVID-19 pandemic.

The pandemic has resulted in significant financial market volatility and a global economic slowdown, generating increased claims activity and reduced earnings for a large number of insurers and reinsurers, but has proved to be less of an issue for most AM Best-rated European captives. This can be explained by the following reasons:

A Conservative Investment Allocation

European captives rated by AM Best predominantly follow a conservative investment approach as they do not tend to rely overly on high yielding investment strategies. Investment risk taken tends to be low, with investments held predominantly in short-dated fixed income securities as well as cash and cash equivalents. Material losses stemming from financial market volatility during the first half of 2020 were largely experienced by insurers with high exposures to equities – an asset choice that only occupies a relatively small share of the overall asset allocation of AM Best-rated European captives.

Generally Limited Impact of COVID-19-Related Claims

AM Best-rated European captives have not reported significant underwriting losses related to the Covid-19 pandemic, as they tend to operate in industries that have been able to continue to function through the crisis, and/or have no exposure to lines of business impacted by the pandemic.

In some instances, captives have reported reduced premium volumes driven by the slow-down of their parents' activity. Nonetheless, this has usually been accompanied by a reduction in claims experience in some lines of business (such as motor, general liability and accident risks), offsetting the effect of lower premium levels on underwriting results.

AM Best notes that some of its rated European captives write credit insurance and surety business. These are likely to encounter increased loss experience as the recessionary impact of the COVID-19 pandemic has the potential to lead to higher levels of corporate defaults. AM Best notes that the loss experience in credit and surety lines has been limited as unprecedented state support initiatives across Europe have so far curbed the number of corporate delinquencies.

Captives and COVID-19

At the beginning of the year, as part of its ongoing surveillance, AM Best conducted a stress testing exercise using its proprietary capital adequacy model, Best's Capital Adequacy Ratio (BCAR), to gauge the impact of the COVID-19 pandemic on the financial strength of its rated companies. The stress test addressed a number of risk factors and encompassed an investment and underwriting shock to the balance sheet, impacting net required capital and available capital. Further details of this can be found in AM Best's special report, "Stress Testing Rated Companies for COVID-19" (May 2020).

When applying the COVID-19 stress test to the BCARs of European rated captives (based on estimated financial positions at year-end 2019), there was only a small decline in the standard BCAR scores at the 99.6 value at risk level for all but one captive. The captive that saw a larger drop in its COVID-19 stressed BCAR had a larger proportion of equities in its investment portfolio relative to peers. For the others, the modest impact was mainly due to their low exposure to investment risk relative to their large capital buffers.

The underwriting shock in AM Best's COVID-19 stress test, which assumed a moderate increase (5%) in loss ratios for certain commercial lines of business, had only a marginal impact on the captives' BCAR scores, reflecting their generally modest underwriting leverage.

With captives overall having been resilient to the challenges brought by the spread of COVID-19, AM Best expects the sector to benefit from opportunities presented by the response of the wider insurance industry to losses caused by the pandemic.

Claims (incurred or expected) on a wide range of lines, including business interruption, event cancellation, credit and surety, workers' compensation and directors' & officers' (D&O) liability, have prompted many commercial carriers to restrict their cover and explicitly exclude pandemic exposures in their wordings.

As a result, AM Best expects increasing opportunities for some captives to offer tailored insurance protection to plug holes in their parents' insurance programmes. This might include broadening their coverage to include pandemic scenarios. A captive which offers business interruption capacity to only its parent can strictly control the limit provided for pandemic-related coverage, without being subject to the accumulation problems of commercial insurers that offer capacity to many different businesses. However, reinsurance capacity may be limited for such cover, which may lead to captives retaining a high proportion of it.

V – Update on AM Best's European Captive Ratings

AM Best's ratings of European captives are typically very stable, with little movement year on year (see **Exhibit 3**). While most of the ratings were affirmed and their stable outlooks maintained over the past year, the ratings of Delvag Versicherungs-AG, the captive of German airline Deutsche Lufthansa Aktiengesellschaft (Lufthansa) were downgraded by one notch in August 2020. The downgrades reflected a weakening in Lufthansa's credit profile, resulting from the decline in aviation traffic caused by the COVID-19 pandemic.

VI – Update on the Building Block Assessments of Rated European Captives

Methodology

To determine the ratings of captives, AM Best uses the same building block approach as it does with other insurers (see **Exhibit 4**). Included in this approach are quantitative and qualitative

Exhibit 3

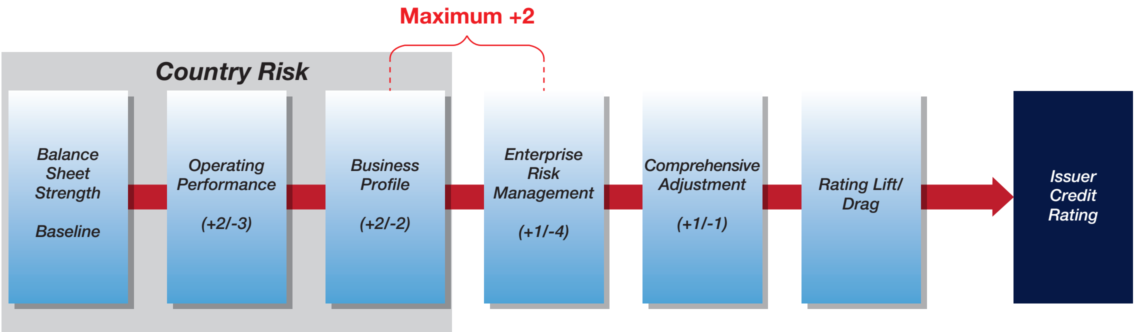
European Captives – AM Best-Rated Companies

Ratings as of Nov. 19, 2020

AMB #	Company Name	Domicile	Best's Long-Term Issuer Credit Rating (ICR)	Best's Financial Strength Rating (FSR)	Best's ICR & FSR Action	Best's ICR & FSR Outlook	Rating Effective Date
94157	Builders Reinsurance S.A.	Luxembourg	a-	A-	Affirmed	Stable	2-Oct-20
85437	Delvag Versicherungs-AG	Germany	a-	A-	Downgraded	Negative	28-Aug-20
94069	Enel Insurance N.V.	Netherlands	a-	A-	Affirmed	Stable	10-Jul-20
90115	Eni Insurance Designated Activity Company	Ireland	a	A	Affirmed	Stable	11-Nov-20
94271	GreenStars BNP Paribas S.A.	Luxembourg	a+	A	Affirmed	Stable	11-Sep-20
57796	Jupiter Insurance Limited	Guernsey	a	A	Affirmed	Stable	5-Aug-20
90728	Kot Insurance Company AG	Switzerland	bbb+	B++	Assigned	Stable	2-Oct-20
86910	National Grid Insurance Company (Isle of Man) Limited	Isle Of Man	a	A	Affirmed	Stable	23-Apr-20
91466	Nova Casiopea Re S.A.	Luxembourg	a-	A-	Affirmed	Stable	19-Dec-19
95043	Sigurd Rück AG	Switzerland	a-	A-	Affirmed	Stable	6-Dec-19
56958	Solen Versicherungen AG	Switzerland	a+	A	Affirmed	Stable	19-Jun-20

Source: BESTLINK *Best's Financial Suite - Global*, AM Best data and research evaluations of balance sheet strength, operating performance, business profile and enterprise risk management (ERM). An evaluation of the wider group is also undertaken to determine whether any rating lift or drag should be applied to the assessment.

Exhibit 4
AM Best's Rating Process – Building Blocks



Source: Best's Credit Rating Methodology

Exhibit 5
AM Best's Ratings Process – Positive, Negative, or Neutral Adjustments from Baseline Assessment

Balance Sheet Strength Baseline	Operating Performance (+2/-3)	Business Profile (+2/-2)	Enterprise Risk Management (+1/-4)
Assessment	Assessment	Assessment	Assessment
Strongest	Very Strong +2	Very Favorable +2	Very Strong +1
Very Strong	Strong +1	Favorable +1	Appropriate 0
Strong	Adequate 0	Neutral 0	Marginal -1
Adequate	Marginal -1	Limited -1	Weak -2
Weak	Weak -2	Very Limited -2	Very Weak -3/4
Very Weak	Very Weak -3		

Source: Best's Credit Rating Methodology

The first step is an evaluation of balance sheet strength, the outcome of which (the baseline assessment) is represented on AM Best's Issuer Credit Rating (ICR) scale (e.g. bbb+). Next, the other rating factors – operating performance, business profile, and ERM – are evaluated (see **Exhibit 5**). The analysis of each of these rating factors results in a positive, negative or neutral adjustment from the baseline assessment. The final step in the process is a determination of any rating lift or drag from the wider group. Full details of the process can be found in "Best's Credit Rating Methodology (BCRM)" on AM Best's website. It should also be noted that there are a number of specific considerations in determining the rating of a captive, which are set out in AM Best's *"Alternative Risk Transfer"* criteria.

Balance sheet strength

As shown in **Exhibit 6**, AM Best-rated European captives all have balance sheet strength assessments of Very Strong, the second highest category available.

Underpinning the Very Strong balance sheet assessments is risk-adjusted capitalisation at the Strongest level as measured by AM Best's BCAR.

All of the European domiciled captives rated by AM Best have BCAR scores above 25 at the 99.6% value at risk confidence level as shown in **Exhibit 7**. The BCAR scores of the majority of the captives have remained stable over the last rating cycle, with four rated captives recording a notable increase in BCAR score due to good organic capital generation. The high BCAR scores support the ability of AM Best-rated European captives to assume more risks from their owners, if needed.

The robust risk-adjusted capitalisation of rated captives is also reflected in their excellent regulatory solvency ratios, with available capital usually exceeding capital requirements significantly.

The parents of captives rated by AM Best are generally supportive of the high levels of solvency maintained, recognising that the captives should be able to absorb worst-case scenario losses without requiring additional funding.

Exhibit 6
European Captives – AM Best-Rated Companies – Building Blocks Assessments
Correct as of Nov. 19, 2020

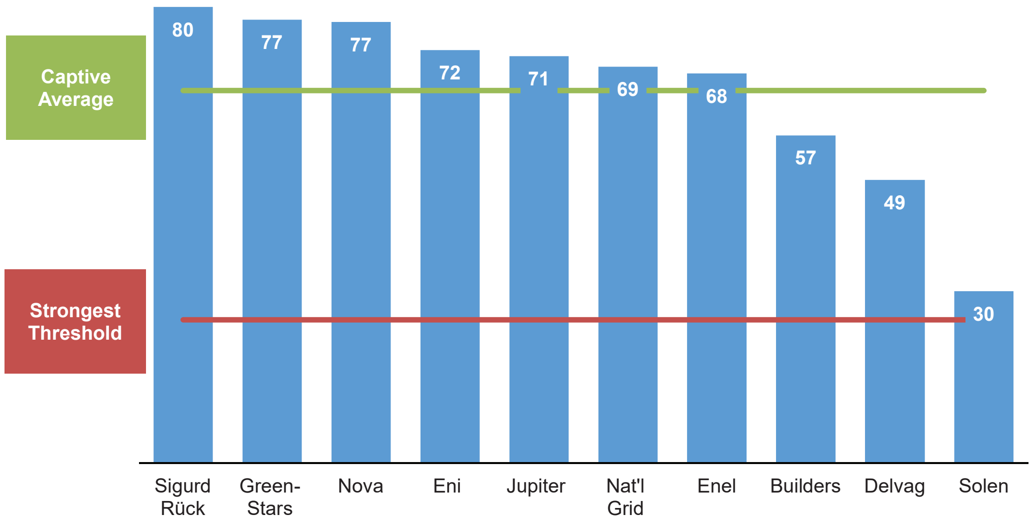
AMB #	Company Name	Domicile	Balance Sheet Strength Assessment	Operating Performance Assessment	Business Profile Assessment	Enterprise Risk Management Assessment	Lift/ Drag	Rating Effective Date
94157	Builders Reinsurance S.A.	Luxembourg	Very Strong	Strong	Limited	Appropriate	None	2-Oct-20
85437	Delvag Versicherungs-AG	Germany	Very Strong	Strong	Neutral	Appropriate	Drag	28-Aug-20
94069	Enel Insurance N.V.	Netherlands	Very Strong	Adequate	Neutral	Appropriate	None	10-Jul-20
90115	Eni Insurance Designated Activity Company	Ireland	Very Strong	Strong	Neutral	Appropriate	None	11-Nov-20
94271	GreenStars BNP Paribas S.A.	Luxembourg	Very Strong	Strong	Neutral	Appropriate	Lift	11-Sep-20
57796	Jupiter Insurance Limited	Guernsey	Very Strong	Strong	Neutral	Appropriate	None	5-Aug-20
90728	Kot Insurance Company AG	Switzerland	Very Strong	Strong	Neutral	Appropriate	Drag	2-Oct-20
86910	National Grid Insurance Company (Isle of Man) Limited	Isle Of Man	Very Strong	Strong	Neutral	Appropriate	None	23-Apr-20
91466	Nova Casiopea Re S.A.	Luxembourg	Very Strong	Adequate	Neutral	Appropriate	None	19-Dec-19
95043	Sigurd Rück AG	Switzerland	Very Strong	Strong	Neutral	Appropriate	Drag	6-Dec-19
56958	Solen Versicherungen AG	Switzerland	Very Strong	Strong	Neutral	Appropriate	Lift	19-Jun-20

Notes:
Lift/Drag: Full details available in Best's Credit Reports for AM Best-rated companies.
Source: BESTLINK *Best's Statement File - Global*, AM Best data and research

Exhibit 7

Balance Sheet Strength – AM Best-rated European Captives BCAR Scores @ 99.6% Value at Risk Level

(%)



Note:
BCAR scores as shown in companies' credit reports on AM Best's website as of Nov. 19, 2020.
The BCAR score of Kot Insurance Company has not been included as it was not published at the time of writing this report.
Source: AM Best data and research

The parents of captives often require large insurance limits to cover their high-value assets. The rated captives use a number of different strategies to meet this requirement, which affects the balance sheet strength assessment in different ways. For example, captives that provide the large limits their parents need and buy little or no reinsurance coverage require very large capital bases to absorb potentially high losses. Other captives purchase significant amounts of reinsurance. Those that follow this strategy can operate with smaller capital buffers, but are dependent on their reinsurers to provide the high limits their parent organisations require.

Reinsurance dependence exposes companies to fluctuations in pricing and capacity. To mitigate the risks associated with reinsurance dependence, captives tend to buy cover from a panel of reinsurers of sound credit quality. Strong enduring relationships are typically built with lead reinsurers, and reinsurance contracts are usually written back to back with inward contracts.

Investment risk taken by European captives tends to be low. For some captives, a large proportion of their investments comprise intercompany loans, which increases capital efficiency from the perspective of the parent organisations. These loans typically have very modest investment yields, but are structured with highly liquid terms and short durations in binding arms-length agreements.

Operating performance

The operating performance assessments of the rated European captives (see **Exhibit 6**) are currently either Strong or Adequate. Captives with a Strong operating performance assessment generally have a track record of excellent underwriting profitability, although results are subject to a high level of potential volatility from exposure to high-severity, low-frequency losses. Due to the nature of the business written, periods with benign claims experience can be followed by high loss years and a sharp deterioration in operating performance metrics. Notwithstanding this volatility, many captives still have operating metrics that, viewed over a long timeframe, support a Strong assessment.

Captives' operating performance tends to be driven by underwriting results, with investment income contributing relatively little to overall earnings. Return on equity metrics are often subdued because of the high level of capital maintained. As a result, AM Best's analysis typically puts greater emphasis on trends in underwriting performance.

The robust underwriting performance of single-parent captives is underpinned by their extensive and detailed knowledge of the portfolios they cover, which supports adequate pricing. Therefore, if achieving an underwriting profit fits with their strategic aims, they typically achieve the metrics required for a Strong operating performance assessment.

Some captives aim to achieve a breakeven underwriting result over time as a way of meeting their principal objective of serving their parent organisation by providing cost-effective insurance. The performance metrics of these captives tend to support an AM Best operating performance assessment of Adequate rather than Strong. An Adequate assessment may also be applied to captives with a limited track record and in cases where the level of historical underwriting profitability does not support a Strong assessment, usually owing to volatility.

Captives' underwriting performance is often bolstered by expense ratios that are usually lower than those of commercial insurers. This can be achieved as, given the simple structure of most captives, required resources are limited. In addition, acquisition expenses are rare and fronting fees tend to be relatively low.

Investment income typically makes a small overall contribution to the earnings, reflecting conservative investment portfolios and the low interest rate environment.

Business Profile

Typically, the European captives rated by AM Best fulfil the majority of the parent organisation's insurance needs, with relatively little primary cover placed outside the captives. This ensures that the parent organisation has access to claims data and loss information across its different business segments and perils.

The business profiles of these captives are assessed as either Neutral or Limited. Most have Neutral business profile assessments, reflecting their importance to their parent organisations and their somewhat diversified portfolios by product line and geography. Those assessed as having a Limited business profile meet only a part of their parents' insurance needs, and consequently have a lower importance to their parents. In addition, captives with Limited business profiles tend to write very concentrated portfolios of business with a focus on high-risk products.

ERM

At the time of writing, the ERM assessments of all European captives rated by AM Best are Appropriate. This reflects generally developed risk management frameworks and risk management capabilities that are appropriate for the captives' risk profiles. AM Best notes that the level of integration with the ERM functions of parent organisations varies, ranging from established local ERM functions that work alongside those of the parent to ERM arrangements that are deeply embedded and integrated into the larger group.

In AM Best's opinion, ERM at captive organisations has improved in recent years, partly as a consequence of preparing for and adopting the EU's Solvency II regime. Regulatory requirements such as Solvency and Financial Condition Report (SFCR) disclosures (where required) and ORSAs have enhanced EU captives' understanding of their own risk profiles. Consequently, most of the AM Best-rated European captives have strengthened their risk management frameworks and governance and can better illustrate their risk management framework and capabilities during the interactive rating process.

Furthermore, AM Best has noted that captives domiciled outside the EU have generally adopted ORSA modelling exercises as well.

Lift/Drag from the Parent Organisation
AM Best's analysis includes an assessment of the ultimate parent to determine whether the credit profile of the parent should influence the rating. This includes an evaluation of the owner's ability and willingness to support the captive.

AM Best's analysis of a non-insurance parent organisation includes an assessment of publicly available credit measures and market-based credit measures, as well as independent financial analysis. Publicly available credit assessments include the credit ratings assigned to the parent by other credit rating agencies with expertise in that particular industry.

Based on this analysis, the ultimate parent may be viewed as having a positive, neutral or negative impact on the rating, expressed through rating lift or drag. This evaluation depends not only on the creditworthiness of the parent, but also on how the captive's creditworthiness might be affected by it.

The results of AM Best's assessments of the impact of the ultimate parents on the European captives it rates can be seen in **Exhibit 6.**

GUIDE TO BEST'S FINANCIAL STRENGTH RATINGS – (FSR)

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. In addition, an FSR may be displayed with a rating identifier, modifier or affiliation code that denotes a unique aspect of the opinion.

Best's Financial Strength Rating (FSR) Scale

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

* 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 "-".

Financial Strength Non-Rating Designations

Designation Symbols	Designation Definitions
E	Status assigned to insurers that are publicly placed, via court order into conservation or rehabilitation, or the international equivalent, or in the absence of a court order, clear regulatory action has been taken to delay or otherwise limit policyholder payments.
F	Status assigned to insurers that are publicly placed via court order into liquidation after a finding of insolvency, or the international equivalent.
S	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.
NR	Status assigned to insurance companies that are not rated; may include previously rated insurance companies or insurance companies that have never been rated by AM Best.

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, business profile and enterprise risk management 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 Rating Services, Inc. (AM Best) 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 AM Best.

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GUIDE TO BEST'S ISSUER CREDIT RATINGS – (ICR)

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. An ICR may be displayed with a rating identifier or modifier that denotes a unique aspect of the opinion.

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

Rating Categories	Rating Symbols	Rating Notches*	Category Definitions
Exceptional	aaa	-	Assigned to entities that have, in our opinion, an exceptional ability to meet their ongoing senior financial obligations.
Superior	aa	aa+ / aa-	Assigned to entities that have, in our opinion, a superior ability to meet their ongoing senior financial obligations.
Excellent	a	a+ / a-	Assigned to entities that have, in our opinion, an excellent ability to meet their ongoing senior financial obligations.
Good	bbb	bbb+ / bbb-	Assigned to entities that have, in our opinion, a good ability to meet their ongoing senior financial obligations.
Fair	bb	bb+ / bb-	Assigned to entities that have, in our opinion, a fair ability to meet their ongoing senior financial obligations. Credit quality is vulnerable to adverse changes in industry and economic conditions.
Marginal	b	b+ / b-	Assigned to entities that have, in our opinion, a marginal ability to meet their ongoing senior financial obligations. Credit quality is vulnerable to adverse changes in industry and economic conditions.
Weak	ccc	ccc+ / ccc-	Assigned to entities that have, in our opinion, a weak ability to meet their ongoing senior financial obligations. Credit quality is vulnerable to adverse changes in industry and economic conditions.
Very Weak	cc	-	Assigned to entities that have, in our opinion, a very weak ability to meet their ongoing senior financial obligations. Credit quality is very vulnerable to adverse changes in industry and economic conditions.
Poor	c	-	Assigned to entities that have, in our opinion, a poor ability to meet their ongoing senior financial obligations. Credit quality is extremely vulnerable to adverse changes in industry and economic conditions.

** 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 (Short-Term ICR) Scale

Rating Categories	Rating Symbols	Category Definitions
Strongest	AMB-1+	Assigned to entities that have, in our opinion, the strongest ability to repay their short-term financial obligations.
Outstanding	AMB-1	Assigned to entities that have, in our opinion, an outstanding ability to repay their short-term financial obligations.
Satisfactory	AMB-2	Assigned to entities that have, in our opinion, a satisfactory ability to repay their short-term financial obligations.
Adequate	AMB-3	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.
Questionable	AMB-4	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.

Long- and Short-Term Issuer Credit Non-Rating Designations

Designation Symbols	Designation Definitions
d	Status assigned to entities (excluding insurers) that are in default or when a bankruptcy petition or similar action has been filed and made public.
e	Status assigned to insurers that are publicly placed, via court order into conservation or rehabilitation, or the international equivalent, or in the absence of a court order, clear regulatory action has been taken to delay or otherwise limit policyholder payments.
f	Status assigned to insurers that are publicly placed via court order into liquidation after a finding of insolvency, or the international equivalent.
s	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.
nr	Status assigned to entities that are not rated; may include previously rated entities or entities that have never been rated by AM Best.

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, business profile and enterprise risk management 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 Rating Services, Inc. (AM Best) 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 AM Best.

GUIDE TO BEST'S ISSUE CREDIT RATINGS– (IR)

A Best's Issue Credit 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. In addition, an IR may be displayed with a rating identifier or other modifier that denotes a unique aspect of the opinion.

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

Rating Categories	Rating Symbols	Rating Notches*	Category Definitions
Exceptional	aaa	-	Assigned to issues where, in our opinion, there is an exceptional ability to meet the terms of the obligation.
Superior	aa	aa+ / aa-	Assigned to issues where, in our opinion, there is a superior ability to meet the terms of the obligation.
Excellent	a	a+ / a-	Assigned to issues where, in our opinion, there is an excellent ability to meet the terms of the obligation.
Good	bbb	bbb+ / bbb-	Assigned to issues where, in our opinion, there is a good ability to meet the terms of the obligation; however, the issue is more susceptible to changes in economic or other conditions.
Fair	bb	bb+ / bb-	Assigned to issues where, in our opinion, fair credit characteristics exist, generally due to a moderate margin of principal and interest payment protection or other issue-specific concerns that may be exacerbated by a vulnerability to economic changes or other conditions.
Marginal	b	b+ / b-	Assigned to issues where, in our opinion, marginal credit characteristics exist, generally due to a modest margin of principal and interest payment protection or other issue-specific concerns that may be exacerbated by an enhanced vulnerability to economic changes or other conditions.
Weak	ccc	ccc+ / ccc-	Assigned to issues where, in our opinion, weak credit characteristics exist, generally due to a minimal margin of principal and interest payment protection or other issue-specific concerns that may be exacerbated by a limited ability to withstand adverse changes in economic or other conditions.
Very Weak	cc	-	Assigned to issues where, in our opinion, very weak credit characteristics exist, generally due to an extremely minimal margin of principal and interest payment protection or other issue-specific concerns that may be exacerbated by a limited ability to withstand adverse changes in economic or other conditions.
Poor	c	-	Assigned to issues where, in our opinion, poor credit characteristics exist, generally due to an extremely minimal margin of principal and interest payment protection or other issue-specific concerns that may be exacerbated by an extremely limited ability to withstand adverse changes in economic or other conditions.

** Best's Long-Term Issue 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 Issue Credit Rating (Short-Term IR) Scale

Rating Categories	Rating Symbols	Category Definitions
Strongest	AMB-1+	Assigned to issues where, in our opinion, the strongest ability to repay short-term debt obligations exists.
Outstanding	AMB-1	Assigned to issues where, in our opinion, an outstanding ability to repay short-term debt obligations exists.
Satisfactory	AMB-2	Assigned to issues where, in our opinion, a satisfactory ability to repay short-term debt obligations exists.
Adequate	AMB-3	Assigned to issues where, in our opinion, an adequate ability to repay short-term debt obligations exists; however, adverse economic conditions likely will reduce the capacity to meet financial commitments.
Questionable	AMB-4	Assigned to issues that, in our opinion, contain questionable credit characteristics and are vulnerable to adverse economic or other external changes, which could have a marked impact on the ability to meet financial commitments.

Long- and Short-Term Issue Credit Non-Rating Designations

Designation Symbols	Designation Definitions
d	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 (e/f [Issuer Credit] or E/F [Financial Strength] designations) or in default (d [Issuer Credit] designation).
s	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 previously published rating opinion is in violation of evolving regulatory requirements.
nr	Status assigned to issues that are not rated; may include previously rated issues or issues that have never been rated by AM Best.

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, business profile and enterprise risk management 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 Rating Services, Inc. (AM Best) 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 AM Best.

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GUIDE TO BEST'S NATIONAL SCALE RATINGS – (NSR)

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. For more information on the ICR to NSR mapping chart and other relevant information refer to "Best's Rating Methodology" available on the AM Best website. In addition, an NSR may be displayed with a rating identifier or modifier that denotes a unique aspect of the opinion.

Best's National Scale Rating (NSR) Scale

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

** Best's National Scale 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).*

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Version 010320

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