# AM Best Company and Captives

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## AM Best and Captives

- Marketing
- Credibility
- Cost Reduction
- Audit and State / Domicile considerations
- Annual Review

2

# Marketing

- Group Captives and RRG's
- Market acceptance greatly enhanced by rating
- AM Best does allow use of the rating symbol on materials
- Captives are not in guaranty funds and the rating can partially counter this "negative" used against them

USA RISK GROUP 30 YEARS AS THE INDEPENDENT LEADER

AM BEST 3

# Credibility

- "Secretive" image of captives can be addressed by the rating "halo" effect
- AM Best has not suffered the pr hit from the mortgage securities debacle
- The public has a good understanding of the value of a rating
- Rating often required by lenders or business partners for required insurance

USA RISK GROUP 30 YEARS AS THE INDEPENDENT LEADER

AM BEST 4

## Cost Reduction

- Best does not openly disclose fee structure but will range from $30k upwards for initial review
- Annual fee
- The plus can be eliminating fronting for most lines except WC and GL
- This can also reduce collateral posted
- Possible State Tax reductions

5

## Audit and State Exam Considerations

- The AM Best review process involves substantial effort re corporate governance, enterprise risk management and business flow documentation.
- These are the same areas being focused on by (a) annual audits and (b) state exams
- The cost expended on the Best process should reduce the time and expense of the annual audit and the cost and frequency of state examinations

6

# A.M. Best Overview

- Established in 1899, A.M. Best has provided the public with comprehensive and unbiased financial information on insurance companies for more than 100 years.
- Leading worldwide
  - Rating agency
  - Data provider
  - Publishing company
- Began rating:
  - Property insurers in 1906
  - Life insurers in 1928
  - In 2005, recognized as a Nationally Recognized Statistical Rating Organization (NRSRO) by the Division of Market Regulation, U.S. Securities and Exchange Commission.

# The Value of an A.M. Best Rating

- Independent Third Party Oversight
- Validate Financial Strength and Credibility
- Satisfy Regulatory Requirements
- Enhance Access to Reinsurance
- Provides Greater Flexibility Regarding Fronting Arrangements

## Objective of A.M. Best's Financial Strength Ratings (FSR)

To perform a ***constructive*** and ***objective*** role in the insurance industry toward the **prevention** and **detection** of insurer **insolvency**

## Actuarial Considerations

## What Does A.M. Best Do With Actuarial Information

- Analyst reviews the full actuarial report
- In-House actuary, Tom Mount, can be utilized for questions
- Actuarial information used to:
  - Gross up discounts
  - Change loss reserve capital factors
  - Change premium capital factors
  - Debit or credit surplus for loss reserve equity

## Rating Process For Captives

## Key Components


A.M. BEST

13

## A.M. Best's Interactive Rating Process

Rating Recommendation

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Peer Review Committee

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Communicated to Company

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President's Letter

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Public Reports Not Published or Released Until Company has Signed Off on Them

A.M. BEST

## A.M. Best: How Captives are rated differently than Commercial Insurers

Definitions:

- BCAR = Best's Capital Adequacy Ratio, is the proprietary capital model used to determine point in time solvency
- QAR = Quantitative Analysis Report, that is used to assess operating performance in relation to sustainability of solvency
- Market Profile = The Qualitative factors that indicate sustainability of solvency
- CAR = Comparative Analysis Report, that determines ranking in a peer review

## A.M. Best: How Captives are rated differently than Commercial Insurers

What is The Same

- The rating of a captive (as compared to the rating of a commercial insurer)
  - The rating is A.M. Best's opinion of a predicted default rate for a captive – for instance an A- rating means that there is a 5.4% chance of default in the next 15 years
  - A.M. Best's default is different, and precedes structural technical default
- The rating tools used to derive the rating
  - (BCAR, QAR, CAR, etc.)
- The decision process
  - i.e. analytical team, Peer Review Committee, Corporate Rating Committee

## A.M. Best: How Captives are rated differently than Commercial Insurers

What is Different

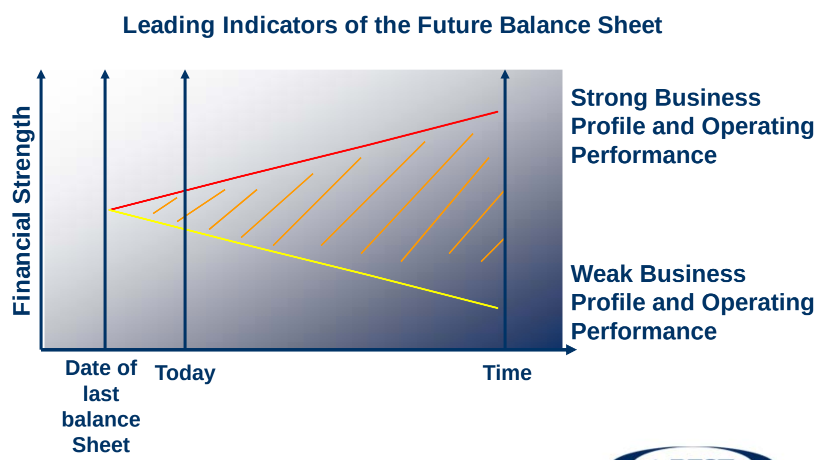
- Dedicated team of 5 financial analysts that only cover captives
- Separate rating methodology for Captives and Protected Cell Corporations (cell captives)
- Market profile assessment has the greatest divergence
- Operating performance stresses preservation of capital and reduction of insurance cost to insureds instead of profitability and return measures
- BCAR treatment

## A.M. Best: How Captives are rated differently than Commercial Insurers

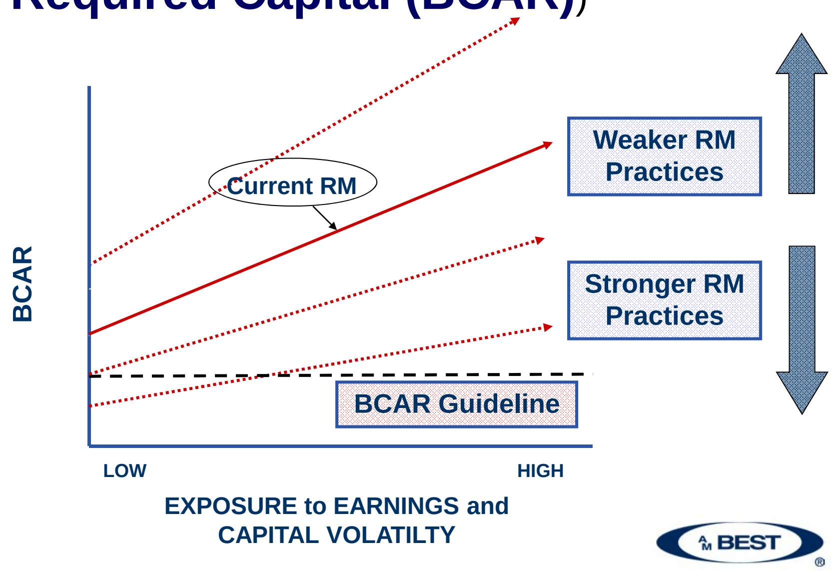
BCAR Differences

- Substitute Capital
- Diversification credit
  - i.e. single state, single LOB, homogeneous insured complexion
- Catastrophe treatment, use of models
- Credit for guarantees, net worth maintenance agreements, demonstrated support
- Factors in tax treatment of business decisions

## Why Business Profile & Operating Performance are Important




## Strong Risk Management (RM) and Required Capital (BCAR))



# Captive and RRG Benchmarking

# Captive Benchmarking - Profitability

| | Captive 5-Yr-Avg | Commercial 5-Yr-Avg | Variance Fav/(Unfav) |
|---|---|---|---|
| Loss & LAE Ratio | 67.4 | 68.7 | 1.3 |
| Underwriting Expense Ratio | 21.6 | 29.4 | 7.8 |
| Combined Ratio (B/PHD) | 89.0 | 98.1 | 9.1 |
| Policy Holder Dividends | 4.5 | 0.3 | (4.2) |
| Combined Ratio (A/PHD) | 93.5 | 98.4 | 4.9 |
| Investment Ratio | 18.2 | 15.3 | 2.9 |
| Operating Ratio | 75.3 | 83.1 | 7.8 |

# RRG Composite Characteristics

- 5-Year Average Net Premium Written of $910 million, Gross Written Premium of $1.9 billion
- 5-Year Average Surplus level of $1.9 billion
- 5-Year Average Loss & LAE Reserves of $2.0 billion
- 5-Year Average Admitted Assets of $4.8 billion

# Performance Statistics

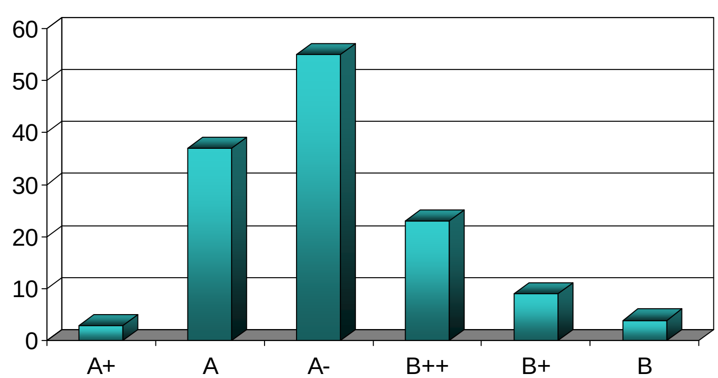
| 5-Year Avg. | RRG Composite | U.S. P/C Industry | Variance – Fav/(Unfav) |
|---|---|---|---|
| Loss & LAE Ratio | 57.4 | 71.1 | 13.7 |
| Expense Ratio | 27.1 | 27.3 | 0.2 |
| Policy Holder Dividend | 2.4 | 0.7 | 1.7 |
| Combined Ratio | 86.9 | 99.1 | 12.2 |
| Operating Ratio | 70.9 | 87.1 | 16.2 |
| Return On Invested Assets | 4.1 | 4.2 | (0.1) |

# Leverage Statistics

| 2010 | RRG Composite | U.S. P/C Industry | Variance – Fav/(Unfav) |
|---|---|---|---|
| NPW to Surplus | 0.4 | 0.7 | 0.3 |
| Net Liab. To Surplus | 1.4 | 1.7 | 0.3 |
| Net Leverage | 1.8 | 2.5 | 0.7 |
| Ceded Leverage | 2.2 | 0.5 | (1.7) |
| Gross Leverage | 4.0 | 3.0 | (1.0) |
| Business Retention | 46.4 | 82.5 | (36.1) |

# A.M. Best Overview - Ratings

Rating Distribution, Rated U.S. Captives



# Capital Management Considerations

## Capital Management Considerations

- Risk-based capital position
- Potential volatility in capital needs
- Ability to underwrite business
- Flexible capital solutions
  - Contingent capital
  - Quota share reinsurance

## ERM is not necessarily "the Answer"

- ***Wide spectrum of tools, techniques, approaches***
- Differences in profile of company, as well as management team skill sets and mind sets, must be considered
  - "ERM is Not One Size Fits All"
  - Approaches range from silo to ERM with ICM, with many hybrids in between
- ***Bottom line is a company's process must fit its profile and provide a sustainable operating platform in good times and bad***

## What is Strong Risk Management?

- Fundamental requirements for strong risk management
  - Demonstrated ability to identify, understand, measure, and manage risk inherent in your business operations
  - Incorporating a recognition of the potential impact of external factors (competitive, legal, regulatory, economic) and emerging
- ***When done right – relative to your risk profile – ERM or a modified traditional approach can be considered strong RM***

## Modified Traditional Risk Management

- Typically, Traditional RM is implemented using a "Silo" approach with little or no formal interaction, communication, or alignment among risk managers
- However, a ***modified*** traditional approach that includes an understanding of how individual risk may be correlated can still be considered strong risk management

## Bottom Line: AMB is looking for a Practical Approach to ERM

- Practical Risk Management
  - Tailored to your business and risk profile
    - Process must fit your company, not the other way around
    - Pick the right tool for the job, not just the most expensive one
  - Function over form
    - CRO's and sophisticated models are not absolute pre-requisites for strong risk management
    - For some insurers, strong risk management may be Modified Traditional Risk Management

## Bottom Line: AMB is looking for a Practical Approach to ERM

- Practical Risk Management
  - Flexible and adaptive to changing business environment
    - Strong risk management is not a finitely defined set of tasks
    - Ongoing process…emerging risks…risk learning
  - Use risk management to
    - Produce a sustainable operating platform that is part of the solution to your state's market issues
    - Position your company to be responsive to market changes

## Practical RM Approach… KISS (Keep It Simple Stupid)

- "RM Questions You Should be able to respond to at every rating meeting"
- Lessons learned through RM Development Process
- Next Steps in RM Development
- Top 5 Exposures and Critical Success Factors to Mitigating/Managing these Risks

## RM Questions to Prepare for at every Rating Meeting

- Describe the involvement of the Board and Senior Management within your risk management framework.
- Has your organization established and communicated risk management objectives to your employees, and other stakeholders?
- How does your organization encourage good risk-based decision making?
- What is your organization's process to identify and catalogue key risks across your organization?

## RM Questions to Prepare for at every Rating Meeting

- What tools does your organization use to determine required capital?
- How do you factor in correlation/dependency of individual risks?
- How do you incorporate operational risk and strategic risk in your evaluation of required capital?
- How are emerging risks identified and evaluated?
- What are the 5 top risks exposures your organization faces, and what are the critical success factors to managing these risks?

# Learn more…

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