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Business Case for Captive Insurers to Get Rated

BENEFITS OF A.M. BEST RATINGS

Captive insurers have many motivations for having an A.M. Best rating–ranging from operational efficiencies to managing market cycles. However, how do captive and risk managers evaluate when to explore a rating for their captive?

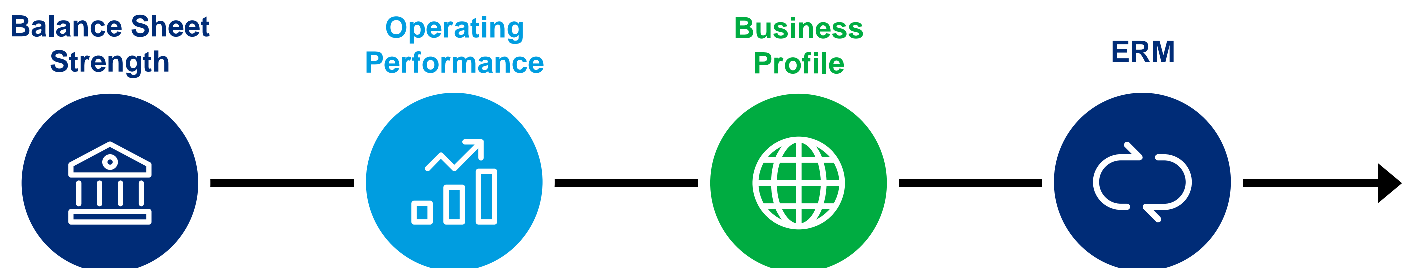
Challenging market conditions in many lines of business and coverage restrictions for non-traditional risks, such as cyber, are driving organizations to turn to captives. Captives have proved to be effective tools in responding to risks and changing market conditions when organizations cannot buy the desired limits or coverage in the traditional market. As a result, captives recently have been more interested in pursuing a rating to improve underlying economics and increase the flexibility of risk transfer options available through the captive.

Many captives choose A.M. Best as the rating agency of choice due to the universal acceptance and prominence of explicit contractual requirements by lenders and business partners that stipulate minimum "Best" ratings for insurance purposes. In fact, Best rates approximately 5% of the more than 3,100 US captives.[1]

A.M. Best's rating methodology for captives (Best ART criteria) generally follows the rating process for all other traditional property-casualty insurers, including assessing balance sheet strength, operating performance, business profile and enterprise risk management. The relationship and stability of the sponsoring organization, an existing alignment of interests and the strategic importance of the captive heavily influence a captive insurer's ratings, unlike those of a traditional insurer.

A.M. Best Credit Rating Methodology

Rating Assessment Path



The core benefits to the captive from having an A.M. Best rating include the following:

- Reduction in fronting and collateral costs.
- Enhanced flexibility provided to the sponsor for hard-to-place risks or non-traditional risks that get too expensive to insure in the open market.

Ultimately, hardening market conditions and the maturity of the captive can change the economics of a captive to a point where a rating may serve as an effective hedge to counter those changes. See the next page for two case studies that outline the benefits of a rating.

A business of Marsh McLennan

[1] Source: Business Insurance/A.M Best

Reducing Collateral Costs

If the captive has a rating, it can write business directly and avoid posting collateral to support its credit risks. Collateral costs increase as the captive grows in premium volume and carried reserves. For long-tail lines, there is a buildup of reserves over time.

Furthermore, as the captive ages and loss reserves build up, collateral costs for the outstanding liabilities increase. This can significantly impact the economics of the captive relative to the cost of obtaining and maintaining a rating. The example below highlights the impact on the cost of collateral on liability business insured by the captive through a fronting arrangement with a rated insurer.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Premium	10,000,000	11,000,000	12,100,000	13,310,000	14,641,000	16,105,100	17,715,610	19,487,171	21,435,888	23,579,477
Earned %	90%	90%	90%	90%	90%	90%	90%	90%	90%	90%
Unearned Prem CY	2,000,000	2,200,000	2,420,000	2,662,000	2,928,200	3,221,020	3,543,122	3,897,434	4,287,178	4,715,895
Loss Ratio	65%	65%	65%	65%	65%	65%	65%	65%	65%	65%
Reserves CY	5,850,000	6,435,000	7,078,500	7,786,350	8,564,985	9,421,484	10,363,632	11,399,995	12,539,995	13,793,994
Reserves PY	-	4,680,000	8,892,000	12,776,400	16,450,200	20,012,148	23,546,905	27,128,430	30,822,740	34,690,187
Total Reserves	5,850,000	11,115,000	15,970,500	20,562,750	25,015,185	29,433,632	33,910,537	38,528,425	43,362,734	48,484,181
LOC (loss reserves + unearned ceded premium)	7,850,000	13,115,000	17,970,500	22,562,750	27,015,185	31,433,632	35,910,537	40,528,425	45,362,734	50,484,181
LOC Costs (%)	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
LOC Costs $	78,500	131,150	179,705	225,628	270,152	314,336	359,105	405,284	453,627	504,842
Collateral/Earned Premium	1%	1%	2%	2%	2%	2%	2%	2%	2%	2%

As you can see, the cost of collateral to support the credit risk of the captive increases over time due to the growth in loss reserves and unearned premium, which can negatively impact the overall economics of a captive.

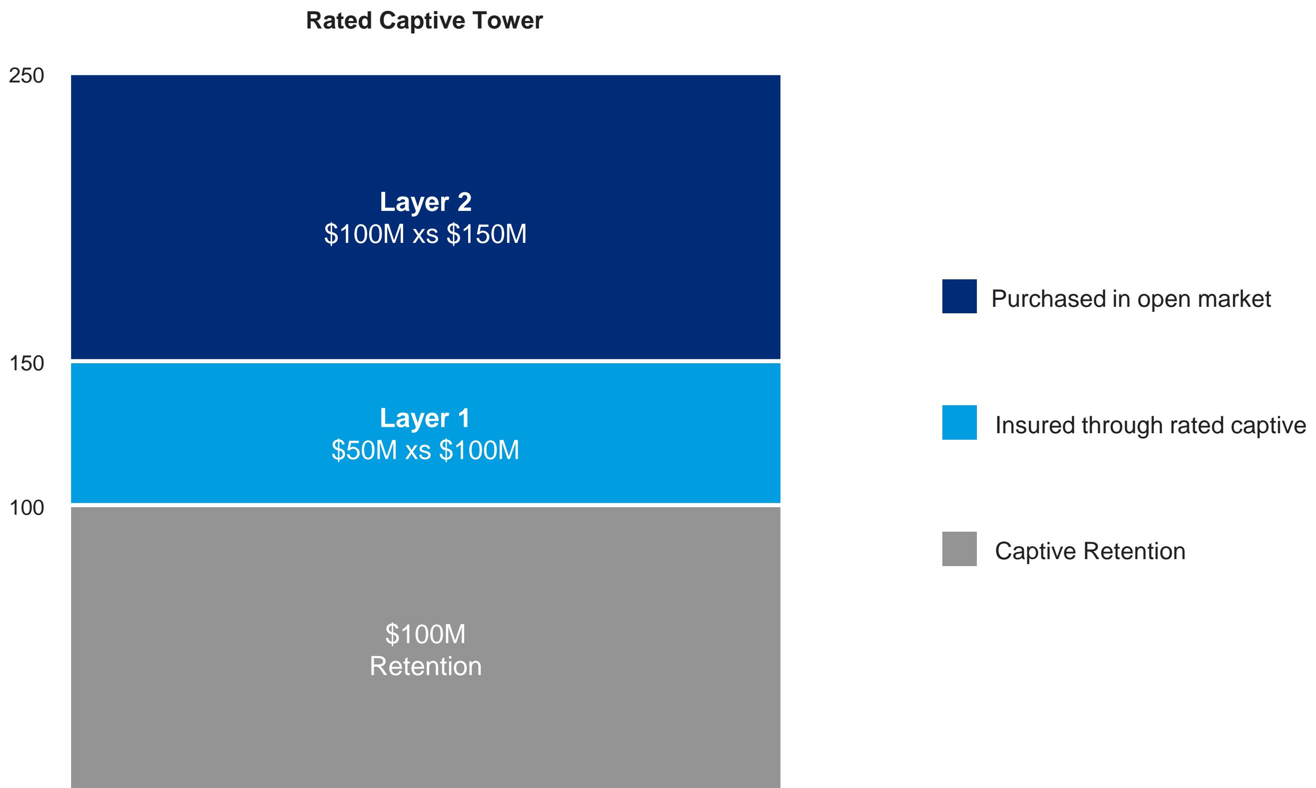
Mitigating Market Cycle Challenges

As discussed earlier, many organizations turn to captives when commercial insurance becomes too expensive or when an organization cannot buy the desired limits or coverage in the traditional market. Generally, this means the appetite in the open market for risks going into the captive under normal conditions may be challenging, which becomes further exacerbated when market conditions harden, or the experience is unfavorable. Additionally, coverage for non-traditional risks, such as cyber, may not be available at reasonable terms, if at all.

The case study on the next page outlines a typical scenario in which a captive assumes large retention and buys insurance in the commercial market for the limits above its risk appetite. In this example, the experience in the $50 million excess of $100 million layer has been poor in recent years, and the price in the commercial market has risen drastically at +40%. However, a rated captive can effectively manage market cycles by assuming 100% of this layer or limit from a front, and then decide the amount of risk to keep net or cede off to a third party via retrocession.

Next, management has taken actions to improve the underlying results. Still, the traditional insurance market has not recognized the benefits in its pricing, thus making the layer uneconomical for the sponsor to continue to purchase in the open market. Often, the market will want to increase the sponsor’s retention when there is an increase in the frequency of severe losses penetrating the retention, making it impossible to purchase the same coverage year over year.

Insurance Layers of Sponsor



With a rated captive, the sponsor has the flexibility to insure the $50 million excess $100 million layer or a portion of it through the captive directly to mitigate pricing and capacity issues while at the same time avoiding the increased collateral costs of a fronting company as outlined earlier.

As more and more organizations turn to captives in response to challenging market conditions and as an effective tool to insure non-traditional risks, the benefits of a rating, in particular an A.M. Best rating, are clear–greater flexibility and reduced costs.

CAPTIVE SEGMENT TEAM

Guy Carpenter's Captive team is committed to delivering solutions to the increasingly complex needs of captive insurance companies. Our Rating Advisory experts are available to help you understand and navigate the rating process. To learn more about how a rating can benefit your captive, please get in touch with a member of Guy Carpenter's Captive Segment Team.

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About Guy Carpenter

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