Article Title: ARCHIVE | Criteria | Insurance | Specialty: Property/Casualty Insurance Criteria: Rating Captive Insurers Data: (EDITOR'S NOTE: — This article has been retired and is no longer applicable.) Captive insurers continue to be a viable, growing alternative to purchasing insurance protection through commercial market participants. According to Standard & Poor's Ratings Services's insurance rating criteria, the assignment of counterparty credit and financial strength ratings to captives is guided by the following factors and considerations: Rating Approach To assign a rating to a captive, it is not essential for Standard & Poor's to have a public rating on the parent. The parent will have to be rated, as this rating is the basis for the rating on the captive, but the rating on the parent need not be made public. Regardless, it will always be necessary to establish a firm view of the parent's financial strength—made possible with the involvement of the appropriate noninsurance Standard & Poor's analyst—before the rating decision on the captive can be made. The main issue to be addressed in rating a captive is whether it is considered core to its parent. Once a captive is considered core, it would be assigned the same rating as its parent. It should be noted that the issues related to the core status of a captive differ from those that determine if an insurance subsidiary is core, which are outlined in Standard & Poor's Financial Services Group Methodology. These are the main issues in determining whether a captive is core: The captive must be a pure captive, which means that it insures and/or reinsures the risks of its parent almost exclusively. Any third-party business must be insignificant compared with the parent risk; it should not exceed 10% of the net written premium or constitute net exposures significantly in excess of—or materially different from—parent risks. When the parent operates a joint venture, it is acceptable for the captive to underwrite risks beyond the joint venture equity stakes of the parent, and premium from such risks should not count for the purpose of the 10% third-party premium ceiling. However, insurance of the parent's customers is considered third-party risk. When a captive exceeds the limitations of a pure captive, Standard & Poor's can consider rating this as a traditional insurer or reinsurer according to standard criteria. In some cases, a captive may choose to underwrite third-party risks of up to 30% of total premium for the purpose of satisfying fiscal requirements, typically to obtain tax deductibility for the premiums paid to the captive by its parent. In such cases, Standard & Poor's will consider whether appropriate underwriting guidelines, expertise, reinsurance, and other factors are prudent enough that the company can still be considered a captive. The captive's strategy should be clearly defined and closely aligned with the parent's risk-financing strategy. Investments in the parent must be of acceptable quality and liquidity. The investment activity must be supportive of—and not equal to or more important than—the insurance operation. The score on Standard & Poor's capital adequacy model must be at least in line with rating on the parent. In addition, the captive should be able to withstand the impact of the largest net loss imaginable without capital falling below a good level of capital adequacy according to the Standard & Poor's risk-based capital model. The captive's reinsurance program must provide complete protection for all risks accepted by the captive, with the exception of the risks that the captive has planned to retain for its own account. No gaps must exist between the limits and conditions provided to the parent and the captive's reinsurance protection, except as planned by the captive and covered by its assets. If a captive does not purchase reinsurance, the captive's exposures must be covered by its assets. It must be able to withstand the impact of the largest net loss imaginable without capital falling below a good level of capital adequacy according to Standard & Poor's risk-based capital model. A captive rating is limited by the rating on its parent. It should be noted that in the vast majority of cases, the rating on the parent will be higher than what would be assigned to the captive if it was considered as a stand-alone insurance company with no parental support. The main reason is that the captive's business position is significantly impaired by the dependency on one client. At the same time, it is important to outline why, in nearly all cases, it is not possible for a captive to be rated higher than its parent. The main reasons are: The industry risk of the parent provides a ceiling for the captive's industry risk. The captive's business position is limited to the parent and fellow subsidiaries. The captive's management and corporate strategy are determined by the parent. Operating performance is generally a reflection of the parent's risk-financing strategy and the role played by the captive. Investments can ultimately be determined by the parent, though some captives determine their own strategy. Capital is provided by the parent, which is normally also in a position to determine the level of dividend. The captive is completely dependent on the parent for financial flexibility. Rating a captive on a public-information basis. Standard & Poor's has decided against rating captives on a purely public information (pi) basis because of the lack of public information available about captives' relationships with their parents, which is a crucial part of the rating. Consideration Of A Captive According To Standard & Poor's Rating Criteria The risks insured by the captive will be closely associated with the industry risks of the parent. Therefore, it is appropriate to use Standard & Poor's opinion of the relevant industry as a guide for the captive's industry risk. This will typically take into consideration any outlook established on the industry in question. In addition, the rating on the parent is likely to provide a ceiling on the view of the captive's industry risk. Business position. For a pure captive, the business position is the insurance and/or reinsurance of the risks of the parent. As such, the captive does not have a business position without the parent. The parent's strategy is to use the captive as a mechanism to finance risks, either as a direct insurer or as a reinsurer of a third-party insurer, a so-called fronting insurer. This dependency on the parent generally leads to the captive's business position being considered good ('BBB' range) but not any better than good because of the complete single-customer dependency. A limitation is when the parent's industry risk is below 'BBB', in which case a view in line with the opinion of the parent's industry risk would be appropriate. Management and corporate strategy. In the analysis, it will be important to determine that the management of the captive—whether through the captive's own employees or outsourcing—has the necessary expertise to implement the strategy effectively and carry out the required operational functions. It is also important that the parent's requirements for sufficient control and management information are met. Operating performance. Operating performance is considered according to Standard & Poor's normal criteria, taking into account that the operating performance is likely to be determined by the risk-financing strategy of the parent. A strategy that aims to break even or accepts very considerable volatility can therefore be acceptable. However, the availability of capital, including an appropriate reinsurance program, will be an important consideration in determining the validity of the strategy. Investments and liquidity. The investment strategy and allocation of assets will be judged according to Standard & Poor's normal criteria and must, in particular, be appropriate to the business underwritten by the captive. Investments in the parent or fellow subsidiaries could fail to meet the quality criteria, result in a concentration charge in Standard & Poor's capital model, and prevent the captive from being assigned the same rating as the parent. Any quality assessment of investments in the rest of the group is likely to be influenced by Standard & Poor's view of the financial strength of the entity in which the investment is made. In extreme cases, Standard & Poor's could decide that the investment activities of the captive—in the parent or elsewhere—significantly exceed the importance of the insurance activities, in which case the assignment of an insurer financial strength rating might not be appropriate. Capital adequacy. Several evaluations will be made, including the need to achieve a score on Standard & Poor's capital adequacy model that is at least in line with the rating on the parent. In addition, the captive should be able to withstand the impact of the largest net loss imaginable without capital falling below a good level of capital adequacy according to the model. The premium and reserve charges are often meaningless for a captive and may, at the analyst's discretion, be substituted by a charge equivalent to the largest imaginable loss. The existence of an appropriate reinsurance program is often the most important stand-alone factor in rating a captive. It is important to note that the failure of a captive's reinsurance program could lead to the group being unable to recover from external reinsurers, which could affect the financial strength on the parent if the amounts are substantial. Accordingly, in most situations, the terms and conditions of a captive's reinsurance protections are expected to mirror precisely those of its captive insurance policies. Reserves are considered as per Standard & Poor's insurance criteria. Financial flexibility. A captive's financial flexibility is normally completely derived from the parent and considered at the parent's level because it is expected that the parent will fully support its subsidiary.