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Rating Methodology

Insurance Company Ratings

Criteria for Rating Cell Captive Insurance Companies

Updated May 2018

Related Methodologies
Global Master Criteria for Rating Short Term Insurance Companies, updated May 2018
Global Master Criteria for Rating Long Term Insurance Companies, updated May 2018
Criteria for Rating Newly Established and Start-Up Insurance Companies, updated May 2018
Criteria for Rating Insurance Companies' Debt and Hybrid Equity Instruments, updated May 2018

Introduction

GCR's Claims Paying Ability ("CPA") ratings are accorded to short term insurers and reinsurers, while GCR's Financial Strength ("FS") ratings are accorded to companies that only conduct long term insurance business. The ratings give an independent opinion of an entity's ability to meet policyholder and assumed reinsurance obligations, however, this excludes funds where investment or other risk rests with the policyholder through a contractual agreement. The CPA and FS ratings are the bases for any other ratings accorded to insurance and reinsurance companies.

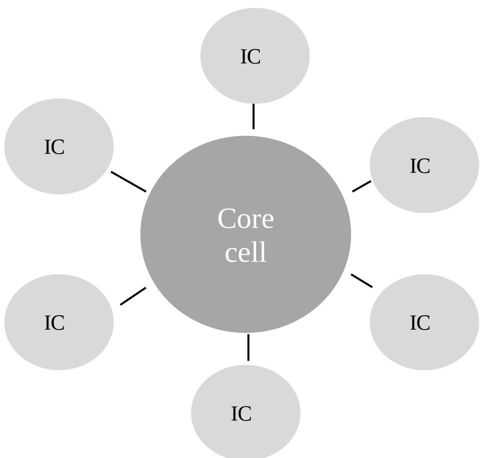
This criteria report ("the Criteria") is an update to the version published in July 2017. No material changes have been made to the Criteria since the date of previous publication. The update of this Criteria will not have an impact on any existing ratings. Going forward, the Criteria will be applied to all ratings of short term insurance and reinsurance companies.

Rating methodology

Overview

The analysis of cell captive insurers incorporates the overarching key rating factors detailed in the Global Master Criteria for Rating Short Term and Long Term Insurance and Reinsurance Companies ("Criteria for Rating Short Term Insurance Companies"), while also addressing the distinctive characteristics surrounding the evaluation of cell captive entities, with particular reference to the business model and nature of the cell captive structure. Various qualitative and quantitative aspects are considered, with emphasis placed on the level of capitalisation of the individual cells and core cells. Key factors considered as part of this exercise pertain to (1) earnings diversification (2) asset management, (3) capitalisation, (4) risk management, and (5) legal and regulatory considerations. The following discussion provides a brief overview of the most pertinent analytical aspects covered under these categories and lists key information generally considered in this regard. This report should be read in conjunction with GCR's Criteria for Rating Short Term and Long Term Insurance Companies available on GCR's website.

Cell captive legal structure



IC: Incorporated Cell Companies

A core cell captive insurance company ("cell captive") is an insurance company that has been separated into legally distinct portions called cells. The cell captive operates a "core cell", or "promoter cell", and allows groups or organisations to buy or "rent" a part of the cell captive's insurance licence. Through the establishment of a contractual arrangement (via the issuance of a special class of shares), the insurer's licence is extended to another organisation ("cell owner"), for the insurance of the cell owner's own risks (known as a 1st party cell) or the risks and/or lives of its customers or members (known as 3rd party cells). The latter may also take a form whereby policyholder participation in the underwriting performance of the risk is enabled (Contingencies). All the risks and rewards associated with certain insurance activities accrue to the cell shareholder, with each cell operating independently. The cell captive insurer would, however, be ultimately responsible for the 3rd party risk insured.

Policy type	Risk transfer	Definition
1st party cell	×	The insurance of risks that relate to the cell owner's own operations, or operations within the cell shareholder's group of companies.
3rd party cell	✓	Allows corporates to sell insurance products to 3rd party policyholders.
Contingency	✓	Allows policyholder to participate in the underwriting performance of a predefined insured risk or set of risks.

1. Legal and regulatory considerations

Given the nature of the cell captive arrangement, consideration is given to the legal jurisdiction in which the entity operates and the accompanying legislative and regulatory framework. A particular type of arrangement under the cell captive structure is that of the *rent-a-captive*, whereby a cell captive either fully or partially capitalises the cell on behalf of the cell owner, and in return receives a fee and/or portion of the underwriting profits. The cell captive structure can also be combined with alternative risk transfer arrangements such as contingency policies, whereby policyholders partially participate in the performance of the cell.

Within this ambit, policyholder protection broadly derives from either legislative or contractual protection. In instances in which legislative ring-fencing of policyholder obligations exist, cell captives are typically defined as a specific type of company in company legislation, primarily Protected Cell Companies ("PCCs") and Incorporated Cell Companies ("ICCs"). PCC and ICC legislation ring-fence individual cells, implying that if one cell should go insolvent, creditors would not be able to lay claim to any assets belonging to other cells.

In other jurisdictions, the ring-fencing of cell's assets and liabilities is effected solely through the governing shareholder agreements between the individual cell owners, and the cell promoter. In such instances, cell captive insurers are typically subject to special insurance licensing conditions. GCR assesses the regulatory framework of the cell-captive in conjunction with the legal jurisdiction.

2. Earnings profile

GCR considers the profit stability and consistency of the individual cells and core cell. The performance of the consolidated cell structure, on both a current and historical basis, is analysed, given that this will ultimately drive future solvency and sustainability of the underlying individual cells within the cell arrangement. Simultaneously, the profitability track record of all underlying individual cells is evaluated, given the direct impact on the cell carrier's profitability and capital requirements over the medium to longer term. A strong cell structure would be expected to reflect, on average, a healthy level of underwriting and operating profitability, relative to the niche cell sub-segment of the market, as well as (where relevant and comparable) the broader industry as a whole.

GCR considers several measures of underwriting and net profitability, and calculates these through the cycle and with reference to market conditions. In this regard, the technical profitability of the cell, at both a gross and net level is considered. The determinants of underwriting profitability in the form of the pricing approach and rate changes are considered, as well as the degree of control over pricing and the adequacy of systems to monitor underlying claims patterns and implement appropriate corrective action. The discussion with management allows for better insight into the underlying trends and business risks, while also contributing to the evaluation of strategic management within the risk management framework.

Core cell

GCR considers the market position of the entity within the cell captive arena and broader insurance market. The maturity of the cell captive, underlying cell(s) and the industry as a whole, are also factors that need to be considered in conjunction with the quantitative aspects. GCR considers the components of the cell captive's earnings to evaluate the sources of profits and the stability of the various profitability measures. In this regard, income fees generated from the management of the cells, investment fees based on investment income on assets under management and other income streams are considered. As such, growth in the premium base, as well as assets under management are evaluated as earnings contributors.

3. Asset management

A cell captive's asset management framework contains certain unique analytical elements relative to traditional insurance operators. The servicing of policyholders obligations extends to the underlying surplus of the respective cell in the event of the cancellation of the arrangement between the cell captive and underlying cell owner.

Viewed in conjunction with capital adequacy and balance sheet quality, the evaluation of assets matching policyholder liabilities and capital are key in respect of both the individual cell(s) and the core cell. This incorporates the capital factors dependent on the investment quality of the assets, their concentration and credit quality of the underlying counterparties. Additional factors reviewed are the cell-agreements between the cell owner and cell-captive regarding the investment mandate. This is considered in order to ensure that the individual cell can meet policyholder commitments underwritten through the cell. Furthermore, any potential mismatch between assets and liabilities, either duration or type, also needs to be considered to ascertain the potential risk to the core cell in the event that the underlying cell is unable to honour its obligations. Note is also taken of the potential credit exposures the cell captive entity has accumulated to the underlying core cell (in the event of a capital shortfall on the underlying cell).

4. Capital adequacy

The adequate capitalisation of both the core cell and individual cell is a key determinant of the longer term financial soundness and credit quality of a cell captive insurer. Cell captive, 3rd party and contingency arrangements result in the cell captive insurer ultimately being liable for all prudential risk of the underlying cells. The core cell effectively acts as a "funder of last resort" in the event that a cell owner is unable to recapitalise the cell to an adequate level.

The cell captive insurer enters into a shareholder agreement with each cell-owner to ring-fence the cell(s) notionally, and ensures that the cell is adequately capitalised on a standalone basis. In this regard, the individual cell needs to be able to withstand the risks assumed in the form of underwriting and investment cyclicality, and the impact of shock scenarios (such as catastrophe losses and investment market corrections). Utilising the independent actuarial valuation provided by the company, GCR conducts a risk adjusted capital adequacy analysis, incorporating a range of factors that impact on the stability of profits and ultimately the company's capital base. More rigorous analysis is performed to the five largest cells (or those cells generating a significant amount of premium volume or those that carry a high risk assumption).

GCR assesses the capital adequacy ratios ("CARs"), at both a regulatory and internal minimum level. The cell surpluses are excluded from CAR computations, allowing for greater prudency when looking at the CAR cover solvency measure, assuming that each cell is ring-fenced and that no cross subsidisation may occur between cells. With regard to the latter, note is taken of the fact that the surplus capital, held by the individual cell owners, is not intended to be used to fund business written by other individual cells, or at the promoter level. Favourable consideration is given to a strong focus on capital adequacy, with an adequate capital buffer above the minimum, and/or contract provisions to issue a capital call to the owners of the cell. In this regard, the agreement with the cell captive shareholders is considered. Financial flexibility is considered in terms of the willingness and ability to provide capital from the ultimate cell captive shareholder (owner). In this regard, GCR will assess the likelihood of support from the parent company/majority shareholders, either in the form of explicit or implicit support. The extent of the rating support derived from the parent/shareholder support depends on the latter's perceived financial strength, which would need to be assessed comprehensively should it be warranted.

GCR analyses the appropriateness of the reinsurance structure relative to the nature and size of underlying risk exposures, as well as the diversification and credit quality of the underlying reinsurers, both for the underlying cells and core cell. GCR assesses the five largest cells and the cell captive's ability to monitor and measure accumulation risk and appropriateness of catastrophe limits. In addition, the cell captive's risk appetite and reliance on reinsurance are factored into the rating. An understanding of the nature of the risk transferred into the cell and the potential exposures based both on a base-case and worst-case scenarios are considered.

5. Risk management

Operational risk management
There is a higher level of operational risk associated with this business model, with the control and monitoring processes key for a cell captive insurer. Accordingly, the evaluation of a company's specific operational controls catering for the unique organisational structure provides clarity and allows for a level assessment of the long term sustainability of the business. A key objective in this regard is to establish to what degree management is able to identify distinct cell captive-related operational threats and address these through the establishment of measures that appropriately manage the resultant risk exposures. Factors beyond the standard risk management assessment pertain to cellular risks regarding operations, underwriting and pricing, asset management, reinsurance and catastrophe monitoring, and reserving.

Strategic management
The strength and longevity of the business strategy is directly linked to the capacity of management to operate the cellular model, and in particular key senior staff and line managers, given their direct operational involvement in the underlying cell(s) and core cell. GCR evaluates the experience and expertise related to the cell captive structure, with insurers displaying a track record of successful management of cellular arrangements positively factored into the overall rating. Similarly, corporate governance factors that enhance the supervision and controls specific to this business model are evaluated.

Appendix A: Explanation of National Scale and International Scale Ratings

GCR's local currency National Scale ratings are designed to enable appropriate differentiation of credit quality within a specific country. Particularly in developing countries, where the sovereign ratings tend to be below investment grade, utilising the International Scale has the consequence of compressing ratings within a limited number of rating bands, thus providing limited differentiation among credits.

In according National Scale ratings, sovereign risk factors are neutralised as it is assumed that all insurers within a given country or jurisdiction will be impacted equally. This allows for ratings to be tiered against an assumed lowest risk rating of 'AAA' within each country or jurisdiction. This lowest risk will normally, although not always, be assigned to the financial commitments issued or guaranteed by the sovereign state. Certain markets may, however, be characterised by inherent limitations that impose a ceiling on the ratings that can be accorded to entities that operate in these markets. National Scale insurance ratings are intended to be comparable only in a single country or jurisdiction (denoted by a special modifier).

On the other hand, GCR's International Scale ratings are tiered against a global pool of insurers. Thus, the highest rating that can be achieved will be limited by the credit quality of the country in which the insurer is domiciled (or conducts the majority of its business). Exceptions can arise where the insurer's rating may pierce the sovereign rating; for example where the entity has significant assets domiciled or revenue sourced offshore, or there are guarantees from foreign entities in place.

Rating insurers on an International Scale introduces additional factors related to sovereign risk, including political risks, the robustness of the legal system and transfer and convertibility risk. While such risks are generally considered when according all insurance ratings, this is done on a more micro level with regard to the specific factors affecting the company or industry under review. For International Scale ratings, a greater macro approach is followed, and the risk factors of the sovereign as a whole are measured against other sovereigns or business jurisdictions.

Political risks are more acute in countries where the democracy is young or even limited. Nevertheless, the principles of good governance and the ability of the government to deliver on development goals are constant across all jurisdictions. Closely related to political risk is societal stability. To the extent there is social instability, the business environment is likely to be negatively impacted and accordingly the rating of entities in the jurisdiction constrained. To the extent that such factors improve, due to solid economic growth or the successful delivery of development plans, ratings would be positively impacted.

Political stability also adds greatly to the strength of the legal system. History has also shown that changes in government can have a destabilising impact on policies and regulations. Well defined and defensible property rights are critical for a strong business environment; while the absence of such rights or weak enforceability would significantly constrain the International Scale ratings of all entities in the country due to the much higher risk. Even where a sound legal system is in place, GCR is cognisant of the fact that in many developing countries historical case law regarding financial transactions may be lacking. This would introduce increased uncertainty into the enforceability of rights detailed in more complex financial products.

Transfer and convertibility risk relates to the ability of insurers in a country to convert earnings between local and foreign currencies and to transfer funds abroad in the normal course of business. Countries where such risks are high tend to be those where currency controls are in place and approval from the relevant authorities is necessary for cross border transactions to occur. Challenges may also occur in small economies, were the currency market does not have sufficient scale to timeously convert large amounts of currency at the prevailing conversion rate. Transfer and convertibility are of greater concern where an insurer generates the majority of its revenue in the local currency but has foreign currency denominated liabilities. If sufficient funds cannot be converted and transferred cross-border, a default on obligations may occur, even when the entity has sufficient financial resources.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S INSURANCE GLOSSARY

Accident	An unplanned event, unexpected and un-designed, which occurs suddenly and at a definite place.
Accounting	A process of recording, summarising, and allocating all items of income and expense of the company and analysing, verifying and reporting the results.
Agency	An insurance sales office which is directed by an agent, manager, independent agent, or company manager.
Assets	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Balance Sheet	Also known as a Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capacity	The largest amount of insurance available from a company. In a broader sense, it can refer to the largest amount of insurance available in the marketplace.
Capital	The sum of money that is invested to generate proceeds.
Capitalisation	The provision of capital for a company, or the conversion of income or assets into capital.
Capital Adequacy	A measure of the adequacy of an entity's capital resources in relation to its risks.
Captive Insurance Company	A company owned solely or in large part by one or more non- insurance entities for the primary purpose of providing insurance coverage to the owner or owners.
Cash	Funds that can be readily spent or used to meet current obligations.
Catastrophe	An event, which causes a loss of extraordinary magnitude.
Claim	A request for payment of a loss, which may come under the terms of an insurance contract.
Commission	A certain percentage of premiums produced that is received or paid out as compensation by an insurer.
Contract	An agreement by which an insurer agrees, for a consideration, to provide benefits, reimburse losses or provide services for an insured. A 'policy' is the written statement of the terms of the contract.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Experience	A term used to describe the relationship, usually expressed as a percent or ratio, of premiums to claims for a plan, coverage, or benefits for a stated time period.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For an insurer, its exposure may also relate to the risk related to policies issued.
Facultative	Facultative reinsurance means reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the “faculty” to accept or reject each risk offered.
Financial Flexibility	The company’s ability to access additional sources of capital funding.
Financial Statements	Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time.
Income Statement	A summary of all the expenditure and income of a company over a set period.
International Scale Rating LC	International local currency (International LC) ratings measure the likelihood of repayment in the currency of the jurisdiction in which the issuer is domiciled. Therefore, the rating does not take into account the possibility that it will not be able to convert local currency into foreign currency or make transfers between sovereign jurisdictions.
Interest	Money paid for the use of money.
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis.
Investment Income	The income generated by a company's portfolio of investments.
Investment Portfolio	A collection of investments held by an individual investor or financial institution.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquidity	The speed at which assets can be converted to cash. The ability of an insurer to convert its assets into cash to pay claims if necessary. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Loss	The happening of the event for which insurance pays.
Market Risk	Volatility in the value of a security/asset due to movements in share prices, interest rates, currencies, commodities or wider economic factors.
Net Profit	Trading/operating profits after deducting the expenses detailed in the profit and loss account such as interest, tax, depreciation, auditors' fees and directors' fees.
Net Retention	The amount of insurance that a ceding company keeps for its own account and does not reinsure.
Operational Risk	The risk of loss resulting from inadequate or failed internal processes, people or systems or from external events. This includes legal risk, but excludes strategic risk and reputational risk.
Personal Lines	Types of insurance, such as auto or home insurance, for individuals or families rather than for businesses or organisations.
Preference Share	Preference or preferred shares entitle a holder to a first claim on any dividend paid by the company before payment is made on ordinary shares. Such dividends are normally linked to an interest rate and not determined by company profits. Preference shares are normally repayable at par value in the event of liquidation. They do not usually carry voting or pre-emptive rights. Preference shares can be redeemable or perpetual.
Policy	The legal document issued by the company to the policyholder, which outlines the conditions and terms of the insurance.
Policyholder	The person in actual possession of an insurance policy.
Pool	An organisation of insurers or reinsurers through which particular types of risk are underwritten and premiums, losses and expenses are shared in agreed-upon amounts.
Portfolio	All of the insurer’s in-force policies and outstanding losses, with respect to described segments of its business.
Preference Share	Preference or preferred shares entitle a holder to a first claim on any dividend paid by the company before payment is made on ordinary shares. Such dividends are normally linked to an interest rate and not determined by company profits. Preference shares are normally repayable at par value in the event of liquidation. They do not usually carry voting or pre-emptive rights. Preference shares can be redeemable or perpetual.
Premium	The price of insurance protection for a specified risk for a specified period of time.
Rating Horizon	The rating outlook period
Reinstatement	The resumption of coverage under a policy, which has lapsed.

Reinsurance	The practice whereby one party, called the Reinsurer, in consideration of a premium paid to him agrees to indemnify another party, called the Reinsured, for part or all of the liability assumed by the latter party under a policy or policies of insurance, which it has issued. The reinsured may be referred to as the Original or Primary Insurer, or Direct Writing Company, or the Ceding Company.
Reserve	(1) An amount representing actual or potential liabilities kept by an insurer to cover debts to policyholders. (2) An amount allocated for a special purpose. Note that a reserve is usually a liability and not an extra fund. On occasion a reserve may be an asset, such as a reserve for taxes not yet due.
Retention	The net amount of risk the ceding company keeps for its own account.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Risk Management	Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.
Securities	Various instruments used in the capital market to raise funds.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short Term	Current; ordinarily less than one year.
Solvency	With regard to insurers, having sufficient assets (capital, surplus, reserves) and being able to satisfy financial requirements (investments, annual reports, examinations) to be eligible to transact insurance business and meet liabilities.
Statutory	Required by or having to do with law or statute.
Statutory Solvency Margin	Gives an indication as to whether the minimum regulatory solvency margin is being met, based on the net statutory assets to statutory net premiums ratio.
Technical Margin	Measures the percentage of net earned premiums remaining after accounting for claims and expenses incurred.
Technical Result	Net premiums earned less net claims incurred and net commission expenses.
Total Capital	The sum of owner's equity and admissible supplementary capital.
Underwriting	The process of selecting risks and classifying them according to their degrees of insurability so that the appropriate rates may be assigned. The process also includes rejection of those risks that do not qualify.