Written by Karrie Hyatt

CAPTIVES AND CREDIT RATINGS, TO RATE OR NOT TO RATE?

For financial companies and traditional insurers, a solid financial strength rating from a nationally recognized statistical rating organization (NRSRO) is imperative to do business. However, for captives—from single parent to group, from large to small—there isn't the same incentive to get a credit rating. That doesn't mean that there aren't good reasons and great benefits to credit ratings for captives.

THE PROS AND CONS

General benefits of a credit rating for all types of financial companies are to show that the company is financially stable, to help facilitate raising capital, to provide transparency, and to help benchmark a company against similar companies.

There are other benefits that are exclusive to captives, such as promoting group cap-

tives to prospective members or helping support a parent company's operations. A captive's good credit rating can also help to improve relations with third-party service providers by helping to secure reinsurance or fronting arrangements. This can be a huge cost saving tool as it makes the reinsurer or fronting carrier more comfortable with the financial status of the captive. Extended benefits for rated captives include satisfying regulatory concerns, enhancing the overall profile of captives, or lowering the cost of the captive's own insurance.

According to Joseph Petrelli, president of ratings agency, Demotech, "To the extent that captives are covering the liabilities of the principals, a good credit rating might not be as important to them as it is to independent third-party insureds. However, a good credit rating might: lower the cost of corporate D&O and E&O; help attract independent board members; assuage the concerns of third-party vendors; help secure umbrella insurance coverage; and assuage the concerns of regulators."

For Tina Bukow, managing director of business development with Kroll Bond Rating Agency (KBRA), "What external benefits are there to a well-rated captive? For one, well-rated captives help to raise the bar for the domicile they are in. Think about it, the more rated captives a domicile has the better that domicile may be perceived, which in turn can help the domicile grow. Also, captives have certainly made their mark in the industry and continuing to promote financial stability via ratings can only enhance their position in the overall market."

While these benefits can definitely help a captive, a rating is not always the best thing for the company. "No company need be rated unless the rating adds value to the insurer's business model," said Petrelli.

According to Bukow, "Very small captives that have a very specific purpose and are tightly held would most likely not find value in a rating. If there is no cost savings, regulatory or board need, and the captive is fulfilling its plan then there is no reason to spend the time or money."

CAPTIVES AND TRANSPARENCY

As captives are privately held, beholden only to their parent companies and policyholders, having a good credit rating is not necessarily required to run a good business. A credit rating gives a captive more transparency in their business operations. In a way, it is relying on a third-party credit rating agency as a de facto regulator and can help put a captive in good stead with non-domiciliary and federal regulators. Captives are only required to financially report to their states of domicile and a financial strength rating from a third-party can help to mitigate outside concerns.

As privately held companies, many captives can find the idea of the transparency that comes with credit ratings concerning. The idea of transparency can make them shy away from seeking a credit rating. While transparency lends credibility to a captive and can bolster its reputation, not all captives want to put their business out in the public domain.

Recognizing this issue, KBRA can help captives get rated without wide exposure. According to Bukow, "KBRA recognizes that captives should be able to reap some of the reward of having a financial strength rating without the public scrutiny that comes along with a published rating and allows them to share an unpublished rating with certain confidential partners—internal Board, regulators, reinsurers, and fronts and/or to fulfil certain contractual requirements."

THE TIME AND THE EXPENSE

A long-held misconception about credit ratings is that the process is time consuming and expensive. Not so, according to Petrelli. "Demotech's review and analysis process is neither expensive nor time consuming. As we have long tenured, experienced, credentialed, insurance professionals as analysts, we are able to review and assign Preliminary Financial Stability Ratings using information that the captive manager has readily available."

It is important to research credit ratings and the agencies that provide them, which includes talking to the agencies to get direct information about pricing. The pricing among credit ratings agencies varies widely, so it is worth it to put in the time to examine not only the different cost structures, but how each agency approaches rating captives.

"As for the time aspect, what is important is education and managing expectations," said Bukow. "It is paramount to the success of the process that the captive has a clear road map of what is expected: data requirements, dialogue, and company meeting expectations (presentations, attendees, etc.). If the company is well prepared and organized the process should be smooth and beneficial."

There is also a misconception that new captives shouldn't seek out financial strength ratings, at least for the first few years of their existence. The thinking is, they wouldn't be able to meet the criteria needed to secure a good rating. For some of the more established rating agencies this may be true.

However, Demotech and KBRA both have processes in which they can rate a start-up company. "KBRA understands and embraces start-ups (it's not that long ago that we too were a start-up, which gives us perspective that others may not have)," said Bukow.

"For example, we understand that maintaining large amounts of stagnant capital on its balance sheet for several years is not optimal for a captive. Also, our credit ratings are forward looking, allowing for greater emphasis on the business plan and management. Our approach allows for greater weight on the experience of the team leading the captive."

According to Demotech's website, they too want to help new captives establish themselves with solid financial strength ratings, "The historical operating results of a relatively new captive insurance company may not be representative of its prospective financial stability." The company uses an evaluation process that applies enterprise risk management principles and practices in their evaluation of newer captives.

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THE CREDIT RATERS

Having a good financial strength rating can, "Prove to your constituents and potential business partners that you are financially secure and serious about your business. Particularly if the rating is from a SEC recognized NRSRO, respected and relied upon by investors in the capital markets and follows an investment grade rating scale. Investors and reinsurers understand the rigor that NRSROs are held to and rely on ratings from agencies with a stellar capital market reputation," said Bukow.

There are a number of agencies that provide financial strength credit ratings. The big three in the international financial markets are Moody's, Standard & Poor's, and the Fitch Group—all with storied histories. A.M. Best is among the most well-known rating agencies for insurance, getting its start in the sector more than a century ago. Two more recent agencies that have made a name for themselves in the insurance sector are Demotech and KBRA.

Each of the latter three companies have different methodologies for assessing the financial strength of captives. A.M. Best's analysis of captives, according to their website, "Offers valuable insight into a captive's organization, its management, governance, and track record. The interactive rating process serves as a roadmap for practicing sound risk management and effective business strategy." Captives are rated under the methodologies for alternative risk transfer vehicles. The rating focuses on enterprise risk management principles that assess the risk management framework and profile of the captive relative to the parent company's business operations.

Demotech, has specialized in evaluating the financial stability of regional and specialty insurers and brings over thirty years of experience to the table. They have a unique process for evaluating captives that was developed in 1989 and it was the first ratings agency to review and rate independent specialty companies. According to Petrelli, this allows Demotech, "In some instances, we have the capability to eliminate fronting requirements, to assist the owners of the captive secure non-recourse loans, and to qualify for savings on their professional liability, D&O, and ICPA (insurance company professional liability)."

KBRA is a recent addition to the list of credit rating agencies, having been founded in 2010. The company takes a holistic approach to ratings, choosing not to rely on a proprietary capital model, allowing them "To rate a captive (or any insurance company for that matter) based on its own unique characteristics and not on an industry standard driven by a model," said Bukow.

For captives, this means that KBRA's "Methodology takes into consideration the nuances that captive insurance companies need to employ based on their reason for existence and relationship with the parent or group. This approach allows a captive to be viewed more accurately and takes into consideration the reasons it exists, allowing for more precise analysis and a more accurate outcome." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.