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FREQUENTLY ASKED QUESTIONS ON PROTECTED CELL COMPANIES: A RATING AGENCY PERSPECTIVE

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Rating agencies are often asked to offer comments on emerging issues. It makes sense, as companies are seeking to make critical decisions on developing their business, or on how to structure a specific transaction, it is critical that management understand how their decisions will be viewed by third parties.

The danger to a rating agency in answering any general questions is the risk that statements are taken out of context. As with any business decision, the facts and circumstances must be understood before a view can be developed.

The following will provide answers to specific questions regarding the use of Protected Cell Companies (PCC). I'll tell you the same thing that I tell my clients: the information in this article may not directly apply to your own specific situation. However, I do hope that you will gain a better understanding of the issues that a rating agency will consider when reviewing the use of a protected cell company.

Question: *It is quite clear by now that Protected Cell Companies are being formed in increasing numbers and utilized in ever more unique and targeted ways to handle risk exposures. From a rating agency perspective, where do you see this going and is it beneficial to the risk management community?*

Answer: There is an interesting dynamic here whereby risk exposures are continuing to evolve and to grow or diminish relative to others as economic, political and social circumstances develop. Concurrently, the ability (and willingness) of commercial insurers to respond to the needs of the risk management community may not arise or be available in a timely fashion. This leads to an ever faster search for solutions, which over time has led to captive formations, group captives and risk retention groups, and now protected cell companies. The flip side to this search for risk financing options is that the entities created to provide the protection may not be capable to respond when needed. This could especially be true, in this case, if a protected cell is so narrowly focused or insufficiently capitalized that its own risk profile may be more volatile than the entity seeking protection from it.

Question: *What key factors should a risk manager be aware of when looking to a protected cell company to handle the exposures of its organization?*

Answer: In order for use of a cell captive to pass muster with senior management and corporate governance mandates, a risk manager should perform as much due diligence on such an option as with any other risk financing solution, maybe more.

Let's look at this in a couple of steps:
If the insured organization establishes its own Protected Cell Company, which will be a licensed insurance organization, and subdivides its risks into a number of protected cells (PC) within the PCC. For all practical purposes, this is similar to establishing a pure captive insurer but with the added feature of being able to monitor lines of business or the results of subsidiary operations on stand alone bases for better allocation of the costs of risk within the parent organization. So long as each cell has the financial flexibility for access to additional funding should it run into claim payment difficulties, this option should be relatively equivalent to that of a pure captive operation.

On the other hand, if the risks of an organization are placed into protected cells which either have no access to additional funding and/or are under the umbrella of someone else's PCC or Core, then a careful review of that PC needs to be performed to ensure that the anticipated protection will exist should it be needed. In this case, the protected cell will have limited ability to pay claims. What will justify its use is if the risk manager is very cognizant of the quantity of risk transferred both on an expected basis and on a worst-case scenario, compared with the capabilities of the PC to respond to those potential claims.

In most cases, due to its smaller size and limited scope, an individual PC will not have sufficient resources to supplement its own should adverse circumstances occur. Its own results, therefore, have the potential to be considerably volatile, unless the scope of coverage is very carefully defined and limited. Nonetheless, due to the flexibility allowed in the contractual arrangements in establishing a PC, mechanisms can be incorporated to allow for various means to either fund the cell adequately up-front for all circumstances, or to have access to additional funding from the PCC or from the owner of the cell. So long as the program meets the needs of the risk manager and is part of the overall enterprise risk management solution, this option should be viable and beneficial.

Question: *Given the potential volatility in the PC, how would a rating agency evaluate a protected cell or the sponsoring PCC?*

Answer: There are some significant dissimilarities between evaluating or rating a protected cell and evaluating or rating a PCC for reasons that are related to their role in assuming risks. For a PC, the mechanism will be somewhat comparable to the process of assigning a financial strength rating to any other type of insurance entity, including captive insurers. The analytical team will examine the PC's financial condition, its risk profile, its actuarially determined loss and IBNR reserves, and the credit exposures it has. In addition, a thorough review will be made of its contractual relationships with other protected cells, if any, and with the core PCC. As mentioned before, financial flexibility and the adequacy of the PC's capital relative to the risks assumed are the critical factors in this analysis.

Utilizing the position that all the risks placed with a PCC organization are at the level of the individual protected cells and that the PCC core does not take any underwriting risks from outside parties, the analysis will focus on the likelihood of the PCC's own capital base being eroded from any contractual relationships it has with the member PCs. This could take the form of capital maintenance guarantees, stop-loss agreements, or similar arrangements with the PCs. Here too, the contracts need to be examined carefully to determine the extent of these liabilities as well as the potential for attachment of funds by a regulator or a court of law in the case of any PC becoming insolvent. In these cases then, a financial evaluation of all PCs, which could have a potential material impact on the PCC, needs to be conducted, regardless of whether those PCs are rated or not, and the aggregate exposure to the PCC must be compared with the PCC's resources to respond to those needs.

It should also be made clear that a financial strength rating on a PCC does not automatically extend to the individual PCs within the protected cell company structure.

Question: *What are the value considerations for a risk manager in determining whether to utilize a protected cell or a protected cell company option?*

Answer: It really is all about risk. The PCC/PC option can provide a very focused and viable tool to manage risks within an organization. It offers a means to assume reinsurance from a fronting carrier and to isolate certain exposures from a more broad-based risk financing program. This may allow a fronting or a commercial insurer to be more responsive to the rest of the needs of a pure captive program. The protected cell taking on the risk, however, will still need to prove to a fronting carrier its risk handling capabilities or little credit will be given to it from a statutory capital relief perspective.

A protected cell also offers a smaller insured an entry into alternative risk transfer options that may be more cost effective than establishing a fully licensed captive insurer. This has the further benefit of giving the insured better control of its risks and their financing and provide it the experience needed should it wish to move to a pure captive in the future.

Control and monitoring of any protected cell captive program is crucial to ensure that the expectations for response to claim incidents will be met, given the capabilities and limitations of the cell captive. There are certain overlying themes and issues that will have an impact on the utility of such a program for the insured. Fronting carriers and reinsurers will also examine them carefully to determine whether such a program could still lead them to shoulder the risks that supposedly have been laid off to the cell. Important considerations include, the type of protected cell that is employed, whether open, closed or some variation in between; what the contractual relationships are among the cells in the program along with that of the core; what is the ability of the cell to absorb shock losses or adverse development; and, what is the regulatory framework under which the protected cell company and the PCs are established and monitored. ✺

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