Module F Unit 8A

UNDERWRITING GENERAL BUSINESS

Purpose

At the end of this unit the participant should be able to demonstrate an understanding of the typical means that the different classes of general insurance business can be written and reinsured by a captive.

Assumed knowledge

An understanding of the various classes of general insurance business written by the traditional insurance markets

Summary of learning outcomes
1. Describe the types of insurance cover typically written by a captive and the ways the captive can participate in these polices.
2. Describe the challenges that a captive can face writing long tail coverages (such as General Liability) and how these can be mitigated.
3. Explain how captives are utilised to respond to risks which the traditional markets have been reluctant to participate.
4. Explain how reinsurance plays an important role in enabling a captive to offer its owner a viable alternative to traditional insurance coverage.
5. Explain how a captive might set about in trying to assist its parent with coverage for uninsurable risks.

In this module we review ways in which a captive can participate in underwriting various classes of insurance for its parent. The aim is to outline some of the more common ways that the different classes of insurances can be written (and reinsured) and present a few ideas. In particular, challenges that might arise with some classes will be highlighted and solutions offered.

By no means is this an exhaustive review as to all the ways and means by which these types of insurance can be written. Insurance portfolios are packaged in a variety of ways and innovative solutions by advisers, brokers and managers are many and varied. You may find your own experience is that some of these classes of insurance are written in different ways to those discussed here. If that is the case try to obtain an understanding from your colleagues as to why a different approach has been taken.

Please note that where the term “burning cost” is used below, this refers to the level of claims activity that is expected every year based upon historical experience. These typically consist of high frequency and low severity claims that are predictable due to the nature of the insured business

8.0 PROPERTY INSURANCE INCLUDING BUSINESS INTERRUPTION

The two most common ways for a captive to write property insurance are the funding of a significant group deductible or writing all of the business, with or without fronting and reinsuring on an excess of loss basis.

8.0.1 Deductible funding

This is where the client would arrange to carry a significant deductible under the primary insurances possibly at two levels. There could be a working deductible of between, say, £1,000 and £10,000 carried by the various insured units and a further deductible on top, say, £500,000written by the captive. This can be arranged whereby the fronting insurer would only get involved in losses in excess of the total deductible and, in a sense therefore, acts more as the excess of loss reinsurer of the captive. However, given the claims handling expertise, it is commonly the fronting insurer that handles all losses on behalf of the client and recovers from the captive the cost of any claims settled that fall to the captive.

The advantage of this method is that the administrative costs of the captive are kept to a minimum and the captive will enter into a fronting agreement. See Unit 9.

The overriding contract is the insurance policy issued by the fronting insurer. The insurer would still regard its involvement as the primary policy and look to price the risk so that an industry normal 60% - 65% loss ratio was generated. Rates and conditions offered by the captive may still be dictated by the market and opportunities to provide flexibility and use of incentivised rating programmes (such as no claims bonuses) would be limited. Nevertheless, it is not an uncommon method of writing the business and it has the advantage of simplicity and being understood and accepted by market players. The captive would have a single negotiation with the insurer at each renewal and thereafter would receive monthly or quarterly bordereaux requesting reimbursement of claims.

However, for property insurance, with the working deductible ideally picking up the majority of small losses, it is unlikely that there would a large volume of claims. So whilst this system is simple, it is not actually avoiding a huge amount of administration.

8.0.2 Writing 100% with reinsurance

A common method of captive involvement would be for the captive to act as the primary insurer (albeit this may also include locations where the captive is writing as a reinsurer behind a fronting company because local admitted insurance policy is required), The captive will either issue a primary policy direct to its insured or a reinsurance contract to the fronting company. It will then decide its net retention based on its risk appetite, business plan and capitalisation, (say, £500,000 each and every loss) and then seek to procure reinsurance protection for all losses exceeding the retention on an excess of loss basis. The retention philosophy is discussed later in this section but basically the aim would be for the captive to write the layer of risk within which all of the potential burning cost losses would fall, in excess of the working deductible such that the captive's reinsurance protection is not penetrated on a regular basis. When this method is used behind a fronting company, the amount of work involved is very little different from that of deductible funding but it will often be found that once the fronting costs plus reinsurance premium spend are deducted the captive is left with more premium to fund its retention than the deductible funding method. This is because the catastrophe cover is being provided by the wholesale reinsurance market with much lower expense ratios and so should be significantly cheaper than the same cover being offered by a primary insurer. Should the business be written directly by the captive, it is not that difficult to write a primary policy, the pricing and documentation being handled by the captive manager, and the usual volume of property claims ought not to create a heavy administrative cost.

8.0.3 Quota share insurance

It is sometimes asked whether a captive should write as a quota share insurer; in effect forming part of a co-insuring panel of insurers on the primary policy. If the aim of this is to avoid the need to buy reinsurance in that the percentage of risk accepted by the captive is within its retention, this is usually not viable. The total sum insured, or at least the maximum foreseeable loss, has to be considered and if this is, say, £100million a retention of £500,000 would mean the captive writing a line of 0.5% and thereby receiving only 0.5% of the initial premium. This quota share method might be considered for some of the larger groups with very high exposures whereby a heavily capitalised captive might write, say, between 30% and 50% of the risk and reinsure it on an excess of loss basis leaving the balance in the market.

By this method the large risks are spread throughout the market without the need for the captive to have a huge reinsurance placement.

The most common approach is for the captive to write up to 90% (with fronting) or 100% of the risk directly and reinsure excess of its chosen retention level. The quota share or coinsurance alternative is normally only considered if the first approach is proving difficult to complete with the fronting insurer or the captives reinsurer.

8.0.4 Retention philosophy

There are various actuarial modelling methods to determine the optimum retention that the parent organisation should carry by combination of working deductibles and in its captive.

These models provide important guidance but they do not always produce a result that is acceptable to the parent organisation. They may well consider a percentage of turnover or annual profit or a percentage of shareholders' funds. These are perfectly viable calculations as to the amount which the parent organisation can incur without any significant effect on its business, i.e. on its profit and loss account or balance sheet. In the final analysis, the risk to reward ratio has to be considered, i.e. the amount of premium saving achieved by carrying a particular deductible or retention against the cost of claims falling within that retention. It is, in general, this risk to reward ratio that dictates the ultimate net retention and the optimum retention and is fairly obvious once reinsurance quotations for various attachment points have been obtained.

A retention of possibly £500,000 with a maximum risk of £100million is referred to above. The reinsurers will assume that most, if not all, of the burning cost will be absorbed by the captive's retention and so they are writing a catastrophe cover of £99.5 million above the captive. If the captive doubles its retention to £1,000,000, this is going to have little or no effect on the reinsurers' ability to offer premium discounts as they will still be providing cover of £99 million in the event of a total loss.–

If the likelihood of any claim breaking through the original £500,000 is remote then although the risk to the captive is small even though it is now retaining £1,000,000, it still has to consider the possibility of this additional exposure.

If, on the other hand, there is a significant chance of regular claims in the range between £500,000 and £1,000,000 then the original retention assessment should have been higher in the first case. Reinsurance terms would probably have been structured to recognise the potential burning costs falling in the £500,000-£1,000,000 range such that a larger and more meaningful premium saving might be offered by the reinsurers in exchange for the captive's retention moving to £1,000,000. At the end of the day it is a matter of obtaining quotations for the captive to hold different retention levels and choosing the retention that provides the best risk to reward ratio.

8.0.5 Aggregate stop loss reinsurance

Whilst the captive can protect itself by excess of loss reinsurance in the event of any single loss exceeding its retention, it can be exposed to an aggregation of multiple claims within its retention. Past experience is a guide but is no guarantee as to what may happen in the future and a series of fires, vandal activity or extremes of weather can easily lead to a multiplicity of individual claims, all to be faced by the captive in one policy period or financial year. Climate change is impacting the severity and frequency of natural catastrophes and has become a real concern for insurers.

The risk of multiple individual losses impacting the captive can be controlled by the purchase of aggregate stop loss reinsurance which will be triggered by the captive's claims exceeding an annual aggregate amount (often expressed as a percentage of the captives' net premium income). This is a particularly valuable reinsurance protection against volatility of loss experience in the early years of the captive until it has built up some retained earnings of its own, over and above its initial capital base.

The captive concept is likely to have been promoted to the parent company board on the basis that it would have the benefit of reinsurance to protect the capital and reduce volatility of earnings and so it is important that this be delivered in the early years at least. Very often, the excess of loss reinsurers will agree, as part of their own package, to include an aggregate stop loss reinsurance within their cover and this is often the most economical means of obtaining this protection.

8.0.6 Loss prevention engineering

Loss prevention engineering is useful to any organisation, whether or not their property insurance is written in a captive but it becomes even more important with captive participation in the risk.

Quite apart from the pure risk management aspects of improved risk and prioritising risk management expenditure, loss prevention engineering can play an important role in the captive's retention and reinsurance programme. A risk that is fully engineered and where it can be evidenced that the insured pays regard to recommendations, is a very attractive piece of business and be viewed as a preferred risk to reinsurers such that it is more likely to attract high quality reinsurers at a more economic cost.

A non-engineered risk with a lack of loss prevention will generate less interest from the reinsurance market and likely to attract a higher premium.

Proper calculations of maximum probable loss and maximum foreseeable loss enables the reinsurers to assess their likely exposure and it might even encourage them to limit their own reinsurance of the risk and thereby reduce their overall cost which can then be reflected in their premium to the captive.

8.1 PUBLIC AND PRODUCTS LIABILITY

For many businesses, public and product liability insurance is, at the lower layers, very much a burning cost cover with premium dictated by historic claims and is therefore very appropriate to be insured by a captive. As there may be a fairly predictable pattern of claims cost dictating the premium, there might be some thought that asking the insured's subsidiaries to carry a deductible would be as good a risk retention method as captive participation but several factors militate against this idea.

Firstly, there would be the difference between the value of a deductible that operating units would be comfortable carrying themselves compared to a substantial group wide retention held by a captive in line with group's risk appetite.

More important than that is the potential accumulation of claim reserves. For example, if the cost of any loss falling within the deductible would come out of that year's operating income. A danger is that several years of notified but not reserved claims would build up and an aggregation of loss settlements in a particular financial period could cause significant fluctuations in the subsidiary's results. With self-insurance such as this it is unlikely that taxation authorities would allow case reserves to be held and certainly not for Incurred But Not Reported reserves.

By comparison, the captive could collect premium in advance, an expense upon which the operating unit would typically obtain tax relief, and then establish loss reserve for reported claims as well as IBNR claims during the current period rather than waiting to book an expense at the date of claim settlement, sometimes many years in the future. The advantage to the insured is that their operating units have a fixed annual premium cost and are not sitting on potentially unknown liabilities. These liabilities are well protected by the loss reserves in the captive with the further advantage that the subsidiaries normally are obtaining immediate tax relief on the premiums rather than having to wait until the claim settlement actually occurs. Further, using the captive provides better control of risk financing, in that the group is aware of their maximum liability. It can help risk management in that all claims are reported and recorded centrally and trends become apparent that an individual subsidiary may not detect so that risk and loss control measures can be brought in to obviate accident black spots or potentially troublesome products.

This is an area where the 'deductible funding' approach as described under property insurance, may be the most suitable. A fronting insurer would write the risk up to an appropriate limit **–** £1 million to £10 million or more – but with a 'deductible' of say, £100,000 each loss, subject to an annual aggregate, with this deductible ceded to the captive.

It is unlikely that it will make sense for a captive to be involved in public and product liability much beyond the burning cost layer. Excess layers over the burning cost can often be purchased in the market economically. Captives, with their single insured and limited spread, are not in the business of writing a 'once in 100 year' risk, whereas the traditional market, writing many hundreds of risks, can achieve an appropriate spread or risk and a pool of premium from which to meet these occasional losses.

Apart from traditional public and product liability cover, captives can be particularly useful in insuring product recall, notoriously expensive in the outside market, insurance of clinical trials for pharmaceutical companies, or defective workmanship. Even when limited cover for such risks is available in the market, it often will be expensive and so it can make sense for a captive to provide cover for such losses.

Whatever liability insurance a captive writes, there are a number of aspects that must be addressed as follows:

8.1.1 Annual aggregate

However a captive writes liability insurance and for whatever risks, it should preferably be written on the basis of a fixed annual aggregate exposure. This applies in fact, to nearly every insurance written by a captive but, such as with property, the remote probability of the number of claims reaching unacceptable proportions can make reinsurance unnecessary once the captive is well established. With liability risks, there is a real exposure to incurring a high aggregate annual amount caused by a multiplicity of claims or a class action) possibly from a single cause.

8.1.2 Occurrence form pyramids

Whether a captive writes its liability insurance on a claims made or occurrence form will largely be dictated by the reinsurers of the excess layers, what cover is available in the market and the attitude of the group risk manager. Certainly, as an insurer, it makes sense for the captive to write on a claims made basis so that it will know that, at the end of the year, the claims notified will be the total of the claims that are going to be made in that policy period. But that approach is not realistic for public and products liability where the occurrence form is more common. This means, in normal circumstances, that claims can be reported several years after the inception of cover. This unforeseen liability is addressed by creating IBNR reserves often based upon careful maintenance of claim triangulations building in trends and changes as appropriate. However, there is still remains a potential long-term risk of under reserving.

Assume, for example, that a new claim cause arises where it is held that its onset goes back over a number of years of exposure just as was the case with asbestosis and claims relative to tobacco consumption.

Vaping devices may yet create liabilities for the manufacturers over the years of their use by a consumer.

Possible risks could arise from the use of mobile phones and associated phone masts where, if they are held to cause injury, claims could be assigned to all the years the phone or mast has been in use.

There is question mark regarding possible electromagnetic force risks generated by overhead electricity wires, particularly where they tend to aggregate at sub-stations.

Nothing has so far been proved but the point to be made is that damage could be discovered in the future creating claim liability on a business going back many years in the past. A captive could thus suddenly be faced with its maximum liability for each of the years it was writing the risk. This is termed as a pyramid of limits and can severely test a captive's resources. Obviously, with an annual aggregate reinsurance protection, the risk is limited between claims already reported for any particular year and the aggregate limit but it could still be a very significant amount for which the captive may have insufficient funds.

This 'occurrence form pyramid' as it is known, needs to be protected. One way of doing this is to limit it whereby although the basic policy is on the occurrence form, it might state that all losses have to be reported within a set time period after expiration date of the policy, say five years. This time limitation on notification is referred to as a 'sunset clause'. This protects the captive but it does mean that the insured group will have to either accept that limitation or the reinsurers of the captive may take on the risk of losses arising after five years i.e. when claims are reported after five years the reinsurance drops down to cover the captives layer of exposure. Sometimes the captive can achieve the same result by agreeing that the fronting insurer buys back the tail of risk – even including outstanding claims – after, say, five or seven years, as later described for employers' liability insurance. Obviously, the extent to which the captive needs protection depends on the extent of its exposure verses it balance sheet but it is a risk that should be addressed.

8.1.3 Claims handling

This process should be agreed with the fronting insurer or primary reinsurer above the captive. It might be thought there is little problem and the captive can easily deal with the routine small claims whilst the larger more complex claims could be handled by loss adjusters and/or the reinsurance market on the excess layers. The problem lies in the fact that the ultimate cost of the claim may not be known in the early stages of notification. What might appear to be a simple claim, may, in fact, be the tip of an iceberg such that the injuries suffered by an individual may deteriorate, increasing the cost or it may be the forerunner of many subsequent claims which can all be traced back to a single source – something perfectly possible with products liability.

The insured may have already started to settle the claims, possibly on the basis of nuisance value, and then be prejudiced when the cost and/or the number of claims escalates. The ultimate cost could well go into the captives reinsurance protections and those reinsurers may claim they have been prejudiced by the early actions of the insured. Conversely, there could be a claim reported for a large amount, reported to the first excess layer reinsurers immediately and which is ultimately withdrawn or settled for a nominal amount albeit after the expenditure of significant legal defence costs.

There could then be the potential for a disagreement as to who is liable for those costs, with the captive's position being that it would not have involved lawyers or spent such money for a claim that ultimately settled for a small amount.

Without going into the relative arguments, these potential confusions indicate that claims handling is an aspect that needs to be considered and agreed with any fronting insurer and the captive's reinsurers. An ideal solution is for an independent claim handling agency, either a loss adjuster or a law firm, to be appointed. But some insured companies have large experienced in-house operations for settling claims and use of these can deliver a more cost efficient and expert service provided that there is close liaison with the captives reinsurers and an outsource agreement in place.

Where cover is written on a deductible funding method, the fronting insurer will be handling all claims for ultimate recovery from the captive and this will, of course, solve many of these problems.

It should be remembered that whilst the captive may make use of others' claims handling services, the decision to reserve for, and ultimately settle, any claim that falls within the captive retention rests with the captive board. It is not unknown for the captive board to adopt a contrary decision to the appointed claims handler and this can lead to difficult conversations with other parties involved in the risk and in a worse case scenarios ultimately lead to legal action between the parties.

8.1.4 Long-term security

Liability business is long-tail business in that there is typically a lengthy period of time between the period of insurance and the date of claim settlement. On certain slow to develop covers, an eight to ten year gap is not unusual. This long tail nature of the risk developing accentuates the problems of security both from the point of view of the fronting company and the insured. In effect, the parties have to make an assessment of the captive's future (sometimes up to 10 years hence) financial standing and ability to pay a future claim.

From a fronting insurer's point of view, it has to evaluate the long- term security of the captive particularly if there is a potential claims pyramid. Whilst it can monitor the performance of the particular insurance which it is fronting into the captive, the captive could get itself into financial difficulties from poor underwriting of other risks. The parent company could be acquired by another company with a different attitude to the captive and withdraw future financial support. Or there might be a take-over of the parent company leading to a break-up of the business and assets sold. For this reason, finding a fronting partner for liability risks can often be more challenging than for short-tail property business. That is not to say that it is impossible to obtain but some insurers need incentivising and there may need to be protections built in such as annual aggregates, an occurrence form pyramid limit and, more appropriately, the posting of collateral such as withholding premium funds due to the captive, establishing Security Interest Agreements or the provision of Letters of Credit for loss and premium reserves.

These collateral requirements can become quite onerous as in subsequent years there is a stacking of the collateral requirements as multiple years' exposures accumulate. Through negotiation, backed by an actuarial assessment of loss development, it may be possible for the overall amount of security to be aligned with the expected ultimate liabilities. See Unit 9 for more on fronting and security requirements

8.2 EMPLOYERS' LIABILITY/WORKERS' COMPENSATION

Most countries have regulations protecting workers with regard to admissibility of employers' liability or workers' compensation insurance such that it is compulsory for firms to place this with a locally licensed admitted insurer. However, the law is often silent relative to levels of deductibles and use of reinsurance so that those locally licensed insurers can reinsure all or most of the risk with their client's captive. The usual way that this is done is with the captive effectively writing a deductible each loss with a limit on annual aggregate exposure. Thus, there might be an insurer writing an employers' liability account who will then cede, say, £100,000 each loss up to £500,000 in the annual aggregate to the captive and retain all losses over these individual claims or the aggregate limit. Thus, a single insurer is acting as a fronting company and the excess carrier, almost acting as the reinsurer of the captive. However, because the insurer will have provided to the insureds any insurance certificates required, it will remain responsible for the settlement of all losses and if, for any reason, it was not reimbursed by the captive the losses remain its liability.

A danger with a single insurer being involved, both at the front end as a fronting company and at the back end as a reinsurer, is that there is the potential to squeeze premium out the captive in that whilst the overall price charged to the parent group might be competitive with other insurers, the split of that premium could be such that the reinsurance element is over-expensive leaving the captive with insufficient premiums to fund the liabilities it is assuming. The allocation of premium is something that needs monitoring, and the manager should alert the captive board if it is felt that the captive is being offered uneconomic terms. That apart, many of the problems and aspects outlined under public and products liability are equally apparent, such as the long-term security problems, the need for an annual aggregate and the pyramiding of limits, there being a high potential of this from newly identified industrial diseases.

Some employers' liability schemes are written on the basis outlined but with a clause whereby the fronting insurer agrees to buy the tail of claims after a predetermined period, say, five or seven years. Such a commutation (return of the liability from the captive back to the fronting company) puts an excellent limitation on the captive's exposure but it can often lead to quite difficult pricing discussions when the commutation takes place as there may be a discrepancy in each parties assessment of the value for outstanding claims and IBNR reserves together with any discounting of those reserves. Nevertheless, with the inclusion of a possible proviso that the captive is not obliged to commute, this can be a very good limitation of risk. In some cases, captives have eliminated their exposure to industrial disease claims by agreeing terms with the fronting insurer such that these losses are not reinsured to the captive. As it is generally this type of claim creating the 'pyramid' referred to, this protects the fronting insurer as well as the captive, from long tail solvency risk.

8.3 PROFESSIONAL INDEMNITY INSURANCE

The lower layers of professional indemnity cover is an ideal candidate for captive treatment for the professional services i.e., accountants, surveyors, lawyers, insurance brokers and Independent Financial Advisors. The last 20 years has seen a significant escalation of such claims and for many professions this has become a significant part of the cost of doing business. Nevertheless, as with the bottom layer of public and products liability, using a captive is an ideal way of funding for these risks in that there can be a significant time gap between the reporting of a loss and its ultimate settlement. If the risk is carried as a deductible by the professional service company, there is the danger of an accumulation of loss settlements in one year whereas using the insurance buying process, with a captive retaining risks falling within the deductible, enables reserves to be established for any incidents notified, risk to be spread over time and a more consistent pricing of the risk transfer year on year.

One point about professional indemnity insurance is that it is traditionally written on a claims made form so that this avoids the pyramiding of limits; claims not reported by the end of one underwriting policy period but subsequently notified will become a claim in the following insurance period. However, the converse of that is that many complaints or incidents can be made to a professional organisation which could be construed as loss notifications which might become significant claims in the future. It is therefore often extremely difficult to agree realistic reserves in the early years and the solution, frequently, is to establish loss reserves equivalent to either the premium received or more conservatively for the annual aggregate limit until such time as there can be some assurance as to the cost of actual claims.

UNDERWRITING GENERAL BUSINESS

8.4 MARINE INSURANCE

Marine liability risks are already broadly taken care of by captive type arrangements, under the Protection and Indemnity (“P&I) Clubs. These P&I Clubs act as mutuals are, in effect, association captives and operate in similar fashion. However, this still leaves hull and cargo risks which tend to be insured in the traditional markets.

Both of these can be profitably written through a captive, particularly marine cargo insurance. Indeed, marine cargo risk can be viewed as a form of customer insurance in that, instead of selling goods free on board f.o.b., leaving the purchase of insurance of goods to the buyer, there could be a move to selling carriage, insurance and freight included c.i.f. with the seller responsible for insurance. This puts the seller in control of the insurance buying process and is particularly valuable when they also control the transportation and have invested in superior risk management and damage control relative to adequate packaging, palletising, shrink wrapping, etc.

A shipper with a superior loss record in respect of transporting goods can either secure cheaper insurance coverage due to performing better than the rest of the industry (and pass that cost saving onto the customer) or, if it has established a captive, can place part or all of the risk into its own risk bearing vehicle. The superior loss experience should translate into profitable business for the captive and aligns the interest of the customer (no damage to their goods being transported) to the shipper (no claims for goods damaged in transit). However, this is not to imply that marine insurance is only appropriate when it relates to customer business; there is much business to business shipping activity going on globally and a portion of that risk is just as appropriately written within the captive as any other form of cover.

8.4.1 Service

Because of the need for claim settling services around the world, marine cargo is almost invariably fronted with the fronting company keeping a portion of the risk (typically 10% – 20%) ceding the balance to the captive. This then secures the services of Lloyds and other claim settling agents. Just as importantly, it means that insurance documentation issued by the fronting company (typically of investment grade quality) is acceptable to any bank around the world thus facilitating international trade through securing of discounting of bills of exchange and the like.

8.4.2 Quota share or excess of loss

With the potentially lower values at risk in any one consignment, compared to property values, it can often be appropriate for a company to consider writing marine cargo insurance on a quota share basis without reinsurance. Where larger values are at risk then the retention with an excess of loss reinsurance on top model is usually more appropriate. With many companies the values are such that either method is a viable option, and it is often a matter of determining the most economic method of risk retention. With a maximum consignment value of, say, £1million a captive could easily write 25% of the risk thus limiting its exposure to £250,000 each loss. For this, however, it would receive only 25% of the original premium, albeit it would only be responsible to settle 25% of any loss that occurred. It might be appropriate in these circumstances for a captive to accept 50% or more on a quota share basis and reinsure ‘total loss only’ so leaving it with the smaller partial losses.

On the other hand, if the captive accepted all of the risk, with a retention of £250,000 each and every loss, it would receive 100% of the premium – or rather up to 90% after fronting – and would likely be able to reinsure in excess of £250,000 each and every loss for a lot less than 75% of the received premium, thus possibly making the excess of the loss basis more appropriate in this example. Against this, of course, the captive would be paying 100% of all losses up to its retention. With lower limits the optimum programme design can change between the two and it is a matter of looking at the market quotations and comparing this with loss experience in order to make a decision. An important point to be considered is the potential aggregation of consignments in one ship or in one warehouse awaiting shipment, which may need specific reinsurance.

Goods in transit, usually relating to transport by road, can be treated either as property insurance or marine insurance depending on whether it is domestic or international. International transport to customers would almost certainly be better arranged on a marine insurance basis but road transport within the insured group of companies, whether it be national or international, could ideally be covered by a captive as the insured may retain closer control of the whole exercise of packaging, loading, transportation and unloading.

8.4.3 Hull insurance

As well as the world's major shipping companies there are many other businesses that own large fleets of vessels for all sorts of purposes. Depending on the size of the fleet it can well be appropriate to involve the captive in the insurance programme. This would usually be fronted with the captive participating either as the carrier of a deductible or as a quota share co-insurer. There tends not to be the same financial advantage in writing a large percentage and reinsuring the excess of loss risk. That apart, the methods of reinsurance for either hull or cargo business are really very similar to that for property insurance.

8.6 MOTOR INSURANCE

8.6.1 Third Party liability

Usually, third party liability is the subject of compulsory insurance issued by locally admitted carrier, certainly so far as personal injury is concerned. It is usually not worth splitting out personal injury from third party damage. If a captive wishes to get involved in this risk, it will certainly require fronting in each and every territory. Except for the largest fleets this tends not to be a particularly profitable line for a captive largely because the margins for this business tend to be fairly narrow, even allowing for the investment income on the claims tail. There also tends to be a fairly hefty fronting fee payable (15% – 20% not being unusual) to cover, amongst other things, significant claims handling costs. Having said that, for large fleets or for car hire companies, there can be a lot of justification in getting involved. For the larger personal injury claims, as with public and products liability insurance, there can be a long gap between notification and settlement. Claims tails of up to ten years are not unusual thus giving the advantage of investment income on reserves.

A problem is that most third party motor covers can have unlimited liability or a liability limit far greater than most captives can accept. This means that additional reinsurance has to be purchased to limit the captive exposure for any one claim and in any one year. The cost of this, added to the fronting fees and claims handling costs, often mean that this cover is not viable for a captive.

8.6.2 Accidental Damage

There is, generally, no compulsory insurance requirement for this cover and so it can be an ideal candidate for captive participation (typically being written largely on a cost plus basis). Thus, if this risk can be written directly by the captive and the commercial insurers' costs eliminated, financial advantage can be derived. The margin between premium and claims is probably a lot less than they might be for other classes but for the large fleets insured it can make sense. It is sometimes argued that rather than use the captive it is better just for the insured to carry the risk. This could well be true but it is necessary to consider the risk of lack of internal cost discipline that this could bring. Where there is no insurance in place there is a risk of road accidents not being reported which reduces control on drivers. This could lead to difficulties in the corresponding third party motor insurance if a third party is involved with little or no damage to the insured vehicle. Accident damage can easily get rolled into maintenance costs and the true cost of accidental damage compared to maintenance of vehicles can become obscure. There is little doubt that the discipline of employees having to report accidents along the lines of a traditional insurance policy, (albeit insured with the captive) makes sense and enables records and statistics to be maintained and analysed thereby controlling driver records and vehicle fleet costs.

8.7 CREDIT AND POLITICAL RISK

Some larger groups do not insure credit, relying on their spread of risk and their own internal credit control. However, there are a number of specialist credit insurance companies who have excellent credit control facilities and are quite happy to work with captives whereby the captive provides a large measure of the risk bearing but the insurer provides the credit control services and acts as reinsurer of the captive. All that needs to be compared is whether this is cheaper and more effective than the internal credit control department.

Where a company buys credit insurance, a captive could certainly be involved behind a traditional insurer acting as fronting company with the captive writing the first, say, £250,000 of each and every risk and the credit insurer acting as excess insurer/reinsurer. Where there are customers or territories that are unacceptable to the insurer, the captive can write these risks directly (or as 100% reinsurer of the fronting company). With many groups there can be sufficient spread of risk to make this model worthwhile, obviously with appropriate lower limits not requiring reinsurance. Clearly no organisation is going to expose itself unduly but it will want to balance the credit risk against the opportunities available. What may be unacceptable to the traditional market can, with proper credit control, be attractive and profitable business to a captive.

The same thinking applies to political risk. Companies expanding their business globally, sometimes into politically unstable countries, can discover the cost of insuring their liabilities on this basis can be extremely high, assuming they are acceptable to the market at all. There is no doubt that the risks associated with trade and investment in emerging markets will increase if there is political instability and so this type of cover remains difficult and expensive to obtain in the traditional insurance market. The captive can fulfil a worthwhile role for organisations operating in the global market by providing a spread of risk across the business. Many insurers require the insured to retain an element of the risk on a quota share basis (to align interests of both parties by "having skin in the game") and the captive can assume this risk (using the market's pricing of the risk).

8.8 MORTGAGE INDEMNITY GUARANTEE

A considerable volume of this business was written in captives in the 1990s. In effect, it was credit insurance of the borrower and is a perfect example of the value a captive can deliver.

It was limited to lending institutions seeking protection against defaults, primarily on high loan to value mortgages. Some business was written by bank captives in the 1980s but the UK Building Societies, who were the major home mortgage lenders around that time, were legally prevented from owning more than 15% of an insurance company until the end of 1992. The change of law came about because of the crisis in the traditional insurance market relative to mortgage indemnity causing excessive premium rates and limited cover. Representations to the government via the Building Societies Commission led to a relaxation of insurer ownership to allow the building societies to form captive insurance companies to write mortgage indemnity business. Since then, many mutual building societies have floated on the stock market and legally become banks which has led to the law being relaxed further such that building societies can now more or less compete against banks and form captives for their own insurance purposes.

Obviously the rules for the creation of captives for mortgage indemnity were subject to a variety of regulations but none of these were other than prudent. In creating a captive the building society had to maintain sufficient funding to enable it to meet a series of losses equal to three times the worst loss experience in the previous ten years. Bearing in mind that the previous ten years, when this rule was set, included the historic worst loss experience of this form of business, this was certainly a very prudent, capital and solvency requirement but perfectly capable of being achieved with the use of reinsurance. This limitation was further modified during the 1990s such that, very broadly, the rule now is that every captive has to comply with the regulations of the domicile in which they reside. This latter is an acknowledgement of the prudent and sensible regulation of captive domiciles.

Captives writing mortgage indemnity earn the premium over eight or ten years based upon the average length of time of a mortgage and an actuarial projection of how losses may arise over that period based upon economic scenarios. Recognition of any profits on the book of business written are typically deferred until a clearer picture of how the book of loans are performing. It is not easy to create prudent loss reserves for mortgage indemnity business; not all arrears and, indeed, not all repossessions, result in losses. The insurance pays the difference between the amount realised on the sale of a property in repossession by the lender and the amount owing to the lender and so typically the longer the period of the mortgage before repossession, should there have been significant house price inflation, then the lower the chance of a deficit and a claim under the mortgage indemnity policy. Unless there are known factors such as a particular adverse trend in a particular area, no appreciable claim reserves are made. This is acceptable because the premium earning pattern is based on claim payments in the past which is monitored and can be adjusted on an on-going basis. The premium earned each year is estimated to cover the claims arising in that year. There is considerable cash flow involved in mortgage indemnity business and the significant investment income generated can be used to bolster reserves should an adverse loss experience (such as an economic recession and a fall in house prices) develop.

Reinsurance was initially a problem for the early captives writing this business. Reasons that the majority of insurers withdrew from the market (or significantly limited their terms and conditions) was not only because of their own losses incurred but because they had also lost their reinsurance facilities. It is probably true to say that by 1990, there was little if any reinsurance capacity available at all on a traditional basis. Nevertheless, captives have always been innovative and by 1993/94 reinsurance facilities had been created on a financial reinsurance basis which enabled the captives to put a limit on their potential exposure and/or limit the amount of capital required to meet the Building Societies Commission rules. These reinsurance facilities came in at varying levels but were usually triggered when individual loss experience exceeded a set % of net premium income. As the trend to use captives grew, the traditional insurers recognised that they were missing out on well managed credit risk business and a number re-entered the market as reinsurers where they tended to write at much higher limits say, 200% excess of 200% of net incoming premium. Some building society captives, who had an appetite for risk, and had generated substantial earnings, were content to apply this capital against this retention of 200% of net premium.

As described above, the 1990's saw the first the round of Mortgage Indemnity captives created by the lenders. In 2012 a different solution was found to lending at high LTV's. The lenders were uncomfortable taking this risk either on their own balance sheet or by way of mortgage indemnity insurance written by their captives. Rather they lobbied the UK Government to be the risk taker so as to encourage and support the building industry to build much needed new homes.

Once again Guernsey provided an innovative solution to this problem in the form of an insurer created as a Protected Cell Company (PCC). HBF Insurance PCC Limited was owned by the Home Builders Federation, funded by builder members with premium and capital paid as a percentage of each new build sale. A separate cell was created for each builder/ lender relationship and the premium and capital paid into that cell. 100 of these cells were created for the major builders in the UK. For the first time in a PCC, multi user cells were created to consolidate risk and premium for those builders without the volume of sales to support operating a single cell.

The UK Government agreed to support this initiative (known as The New Buy scheme) and provided a Government guarantee to HBFPCC of up to £1 billion, which essentially acted as a reinsurance of the PCC. With the premium and capital and the Government guarantee in place HBFPCC was able to satisfy the lenders that the insurance policies issued by each cell offered adequate security for them to lend against new build homes at LTV's between 90 and 95%.

HBFPCC needed three innovations to be able to deliver the required solution. These were:-

- The injection of the premium, for each loan made, together with the capital required for solvency simultaneously. As each house sale was completed and the cell's insurance policy came on risk, it was at that point in time funded by premium and capital. This was an entirely new approach and something only possible due to the flexibility offered by the GFSC.

- The creation of multi user cells which many small builders would access collectively. In Unit 2 it is stated that the assets of one cell must be keep separate and ring fenced from any other cell and the Core assets. In a multi user cell the proposition was to co-mingle the premium and capital injected by several builders. This required the construction of different classes of share in the multi user cell, to be held by different builders. It also required sophisticated contractual Shareholder User Agreements that allowed for sharing of risk within the cell.

- Finally the use of a UK Government guarantee as a form of reinsurance of an offshore insurance vehicle was innovative and required HBFPCC to demonstrate to the Government the existence of robust governance, regulation and contractual security around the operation of the company

Both of these mortgage indemnity solutions for 1990s and 2012 challenges required innovation, flexibility and close co-operation between different regulatory bodies to deliver a captive solution when the traditional market was unable to respond.

8.9 BANKERS' BLANKET BONDS

Although only applicable to banking institutions, many banks have formed captives to participate in their bankers' blanket bond insurance and, as the volume of this business is not insignificant, it is worthy of mention. A bankers' blanket bond is, in simple terms, an insurance product covering the bank against losses arising from fraud, robbery, computer crime and other theft. It has to be stressed that this description is very much an over simplification as the insurance policy is a very complex document. It is relatively expensive and subject to significant deductibles according to the size, complexity and type of business of the insured bank. A minimum deductible of between £1 million and £10 million would not be unusual and the world-wide limit of market capacity available to any one banking institution is probably no more than £400million in the aggregate in any one year. As with most other insurances, the lower levels of risk are the most expensive so banks are looking to protect and smooth their financial results, not only by insuring in the captive the required deductible but also, possibly, some or all of the layers of risk immediately above the deductible (that could otherwise be insured in the market). Therefore, it would not be unusual to see a captive writing so much per claim, representing the deductible level and then a layer on top of that of maybe five to ten times the individual deductible but with an annual aggregate limit.

Many banks still maintain underlying deductibles but these can be of a more moderate amount allowing for the potential aggregation of settlement. A bank with a deductible of, say, £5 million each loss and then cover in the market excess of that, might now carry a deductible of, say, £1 million to £5 million with the captive then writing another £5 million each loss on top of that (subject to, say, £10 million in the year) and then the first aggregate layer of £25 million in the year. Thus, in the worst case scenario the captive could have a maximum annual liability of £35 million. However, the captive would be collecting significant premium for this risk. The earlier comments relating to use of a captive facilitating better risk management and hence reduced claims is particularly apposite.

8.10 GUARANTEE BONDS

These are bonds required by government departments guaranteeing the payment of tax or duty on bonded goods or by customers requiring a bond guaranteeing delivery of performance, completion of a contract or safe arrival of goods. The party requesting the bond is looking for a reliable third party guarantee and so is unlikely to accept a bond provided by a captive; this would at best be equivalent to asking for a bond from the parent which would seem to negate the need for the request in the first place. However, when an insurer issues a guarantee bond they invariably also ask for a 100% counter-indemnity from the insured so that, in effect, all the insured is buying is a third party name's and credit standing and all the insurer is providing is protection to the other party against the risk of insolvency of their insured. The risk is negligible and it would be good business for a captive except that, for the reasons stated, it would be most unusual for a captive to be able to write this business on a direct basis. It is sometimes seen on a fronted basis but the margins are extremely narrow, bearing in mind the limited risk and the insurer is not a lot better off taking on the potential insolvency of the parent group as well as the potential insolvency of the captive (although the fronter will typically ask for collateral as security, as previously discussed), so unless there is a huge volume of business or special circumstances, there is not a lot of premium saving to be made.

8.11 FIDELITY GUARANTEE

For most businesses a fidelity guarantee tends to be a particularly inexpensive form of cover with the risks limited by operational processes, risk management procedures and internal audit controls. Nevertheless, a captive can be used to write the deductible portion or increase a deductible thus reducing the premium spend going into the insurance market, particularly when a company is satisfied as to the effectiveness of its control measures.

Other companies who may have more significant risk by the nature of their business, such as those who employ large numbers of individuals in cash collection, might find a use for the captive on an individual claim and/or aggregate basis to eliminate the potential burning cost risk, leaving the insurance market to cover, at minimum cost, the more traditional fidelity risk.

8.12 DIRECTORS' AND OFFICERS' COVER

This is a complex issue and the discussion below covers the fundamentals only. For many years it was considered that Directors & Officers (D&O) insurance was not well suited to being written by a captive. Depending on the jurisdictions in which cover will apply there can be legal impediments to the parent company (including subsidiaries providing any indemnity to its directors. This is because this would involve the company using shareholders' funds to indemnify the directors against a claim brought against them possibly by those same shareholders. Clearly having the captive provide an insurance policy falls under the same argument regarding shareholder funds and might well also be prohibited. Conversely purchasing D&O from the insurance market is an acceptable transaction.

D&O covers are typically written on a "Claims Made Basis" and as such a captive has little opportunity to build up reserves other than case reserves in response to notifications of incidents on its balance sheet to address large losses as they arise. There is no ability to hold IBNR for insurance written on a claims made policy wording and this is another reason D&O might not be considered ideal for captive participation.

However, society and therefore shareholders and other stakeholders in business have become increasingly more litigious and boards are facing new risks in the business environment. As a result claims against D&O insurance have increased substantially and even where the litigant does not win every case brought, there can be very substantial legal costs for the defendant's insurers.

Given this changed environment D&O insurance has become increasingly expensive and for some businesses or territories very difficult to obtain. There are many exclusions in today's D&O insurance policies and this alone can leave substantial exposure to uninsured risks.

The result is that more captives are seeking to write D&O insurance where they are legally allowed to do so.

So, whilst the basic principles of writing D&O in a captive are little different from those for say Professional Indemnity discussed above, the key matter for consideration is the legality of the cover to be provided. It would be wise for the captive to seek external legal advice before proceeding to issue a D&O policy.

8.13 HANDLING 'UNINSURABLE' RISK

8.13.1 Defining 'uninsurable'

'Uninsurable' risk in this context is deemed to refer to:

- Risks completely uninsurable in the traditional market.
- Risks where insurance might be available but the premium cost is unacceptably high.
- Risks where cover is available but it is offered a limited number of insurers and the overall capacity is limited such that, apart from the dangers of the market disappearing, the capacity probably does not reach the levels of protection required.
- Risks where the capacity available is unreliable and may not be available in the long- term.

Under the latter two categories, it makes no sense to be paying premium into the insurance market for limited capacity, particularly when that market might disappear and be unavailable when the risk manifests itself and the cover required. It makes much more sense for the insured to put such premium funds into its own captive facility which would provide stable cover, over the number of years of the insurance, for its own use. Examples of the covers referred to as above would be:

- Environmental risks.
- Professional indemnity, certainly at the lower layers and for the higher risk professions.
- Political risks.
- Product recall.
- Product trials.
- Treasury risks, such as foreign exchange and interest rate variations.
- Residual value.

It is unfortunate that this is a list that tends to grow rather than reduce. Mortgage indemnity, a very attractive risk and very easy to insure in the 1980s, became uninsurable under this definition at the end of that decade until a solution was created by the use of captives. The items on this list are also more prolific than ever and many, by their nature, can be indiscriminate in terms of the organisations they affect.

Before going forward and finding a financial solution to the exposures, it aids comprehension of the issue to examine why the risk is uninsurable in the conventional market and whether the reluctance of the insurance market is valid? This is, in effect going to the first basic principles of risk management: identifying and quantifying the risk. Having done that, it then follows that a company should consider whether the risk can be modified at reasonable cost to either make it insurable or whether it can be mitigated to such an extent that no other financial provisioning is needed. Obviously, the detail of such an investigation and what can be done varies according to the particular risk that is presenting the problem. For example, if it is a pollution risk, can steps be taken to eliminate the risk by changes in production and storage methods: what is the profit on the product and is production worth continuing? Would it make more sense to cease production or sell the plant? If it is a treasury risk, what steps can be taken to limit it by changes in procedure, by bringing in more levels of control, deeper internal audit and the like? Whatever it is, it would be an unusual risk that could not be modified or reduced, if not eliminated, by the application of risk management principles.

However, even after all controls have been implemented, there may still be a risk left which has to be dealt with and below we outline some of the ways in which a captive can assist a company to protect itself against adverse consequences of such risks.

8.13.2 Outline of the problem

Having identified and quantified the particular risk(s) the challenge is how to protect the company's financial position from loss should the potential adverse event arise. Areas to protect include the following:

a) The current year's profit and loss account

To limit the impact of any loss in a particular year and maintain continuity of profit.

b) The balance sheet

Where the risk is material and could not be absorbed in a single year's profit and loss account, there will be the desire to manage the effect on the balance sheet which might arise if there is a significant increase in liabilities or if there is an adverse impact on the value of shareholders' funds. Ideally, can the risk be removed from the balance sheet altogether?

c) Share price

Sharp fluctuations in share price are to be avoided. Any material decrease in share price has the effect of reducing the value of the company, damaging its reputation and consequently its credit worthiness or gearing, i.e. percentage of borrowings to share value. An event which dramatically undermines a share price can equally rapidly undermine the viability of the company itself.

d) Profit related pay

Many companies incentivise their senior executives and sometimes staff further down the chain, whereby their compensation packages are related to profits. Stability and steady growth are all important and a sudden reduction in profit can have a marked effect on employee relations and risk taking behaviour if a cut in remuneration is threatened.

e) New partners and shareholders relative to old risks

Where pollution risks are concerned it could well be that there is a problem identified today which was the result of events happening decades previously. Similarly, relative to such as professional indemnity, a claim made today against a professional firm could well be the result of the negligent actions of a partner, possibly a retired or deceased partner, many years previously. Actions are undertaken today (often with best intentions) which can give rise to claims many years into the future. It follows that it makes sense for provision to be made today for these undetected risks and it could be argued it is unfair on future shareholders or future new partners to have to suffer the financial consequences as a result of past errors.

8.13.3 Problems of the conventional insurance solution

a) Inconsistent availability of coverage

There are many examples of when the amount of cover available and the price varies during an insurance market cycle. Dramatic changes in premium and availability of cover have been experienced as a result of unprecedented large scale incidents such as the terrorist attacks of 9/11 and ever more active hurricane seasons or other adverse weather events.

b) Low limits

Pollution risks are an example where the market will say that this risk is insurable but then it is found that limits offered are insubstantial and no more than the level of deductible that most companies would be prepared to accept.

c) Restrictive wordings

There are a number of banks that no longer buy bankers' blanket bond insurance on the basis that when they did, whenever a claim was submitted, it then entered into a long drawn out negotiation with insurers as to whether or not the particular claim was covered and the amount of indemnity. This is a problem not just relative to banks, energy companies have experienced similar disappointment in the market's reaction to material claims notifications. There are other examples where, when the claim is material, insurers tend to look for an escape route in the policy wording. Thus, where a company thought it had purchased protection it now finds it has not only the claim to handle but an expensive legal action against its insurers to manage.

d) Disappearance as problems emerge

Again, there are examples of insurance cover disappearing at renewal as the events against which they are providing cover become manifest. Terrorism and flood risks in the UK and mortgage indemnity provide some examples. The risk to the insured is still there and still needs to be controlled.

e) Expensive

Some underwriters might contend that everything is insurable at the right price. By that they mean the right price to them and that may certainly not be a fair price for the insured. An expensive premium rate of course, particularly one that is justified, can mean that the insurance is not being provided against the fortuitous event but, more probably, is against an event seen as inevitable. The lower levels of cover (that response to burning cost losses) tend to fall into the expensive (i.e. high rate on line) category in this context and are better treated outside of the traditional insurance process.

f) No long-term guarantee

Insurers prefer to write on a short term policy period, typically on an annual basis and whilst some may be prepared to write longer term multi-year policies these are still tending to be limited to three years and only for the more predictable traditional risks. There is certainly no long-term guarantee of continuity of cover or consistent pricing of premium. During the 2001 foot and mouth disease outbreak, a case was reported concerning a farmer who had bought foot and mouth disease insurance for over 20 years, without a claim. Insurers refused to renew just at the time when he most needed the cover and 20 years of premium spend was wasted. Neither is there any long-term guarantee as to the security provided by insurers and the financial situation of insurers can vary considerably over time. There have been a number of failures regarding UK insurers and various policyholder compensation schemes have been established to protect insureds, albeit these are aimed at retail consumers and SMEs.

g) Risk spreading effect only

For larger companies, buying insurance, against whatever risks, has the effect of spreading of risk over time. For major groups, spending tens of millions of pounds per annum of premium, it would be unusual were they making a long term 'profit' out of insurers i.e. where total claims reimbursed exceed total premium paid over a five to ten year period. This just might happen for one year in the occasional instance of a particularly severe fire or liability claim but it is certainly the exception rather than the rule.

Any company can buy protection against the true catastrophic risk at a fraction of its overall insurance budget but in general all that an insured group typically buys is the ability to spread claims cost over time. So companies would rather spend £5 million a year to protect themselves against the possibility of, say, a £25 million loss occurring once in five years. The annual premium can be budgeted and included in annual operating costs. But the insurance solution to achieve this risk spreading is expensive (recognising the insurer's overheads and profit need to be factored in the premium) and if a better means can be found (such as use of a captive), then it should be examined.

8.13.4 What the alternatives must provide

So, having criticised the insurance market and highlighted its inadequacies, can the captive provide a better solution? Regarding uninsurable risk, can solutions be found and what must these alternatives provide?

a) Consistency of coverage over the long term

Whatever arrangement is set up needs to be there on a consistent long-term basis and if there is to be any reinsurance protection, there has to be some assurance that the reinsurance capacity will be provided consistently both in terms and in availability.

b) Appropriate wordings

The cover to be provided by the alternative arrangement needs to respond to all, or at least the major part, of the problem risk. There is no point in having a wording that might be just as restrictive in its scope as a traditional policy.

c) Appropriate limits

Major companies should be able to carry significant deductibles and whilst it is true that a captive can facilitate a company take a group deductible that reflect the group's risk appetite thereby protecting its subsidiaries and smoothing out the cost over a period of years, this is still only dealing with the acceptable level of deductible. What is being sought in the current context is a protection well in excess of any deductible layer.

d) Risk spreading effect

Whatever is put in place has to deliver the same risk spreading effect as the market provides on traditionally insurable risks. If there is no spreading over time then the profit and loss account is not protected and there is little point in going through the exercise.

e) Balance sheet protection

The ideal solution is to reach a position where the incident causing the loss does not fall on the balance sheet of the parent at all. The aim is for a steady annual premium paid out of the profit and loss account eliminating the risk and protecting the balance sheet into the future.

8.13.5 Limitations of own retention

Whether retained within the parent company or transferred into a captive, if there is no reinsurance available so that any cover provided is limited to the retention carried by the captive or an internal funds set up against the risk, there are considerable limitations. It is easier to look at this as though the risk was being transferred into a captive but the same principles applies if it is merely self-insured.

a) Capital requirements

With no reinsurance, if the captive is to provide any meaningful level of cover to at least go some way to solving the parent group problems, there will be a requirement for significant capital injection to support this risk. This amount of capital is not to be underestimated. If the desire was to insure a risk of, say, £50 million then, even with an annual premium of up to £10 million, there would be a need for capital of £40 million, following the principle that a captive has to have the ability to pay a maximum claim if the policy it issues is to be truly considered an insurance contract. The parent group will consider other uses to which its capital can be applied and whether allocating this capital to the captive is the best use of a scarce resource (albeit in certain circumstances it is possible for the captive to loan back to group a substantial element of the paid in capital).

b) Is the balance sheet protected?

Even where the captive is sufficiently capitalised, upon consolidation into group accounts many intergroup transactions may be eliminated. There may be the advantage of treating premium as an expense and the ability to create and maintain case and IBNR reserves in the consolidated accounts.

c) Using acceptable premiums

The problem with uninsurable risk is that, by its nature, the premium to risk ratio is going to be difficult to model. Looking at a risk that might arise say once every five years there is still the need for an annual premium of 20% of the sum insured, which may be considerably higher than under a traditional programme, albeit coverage may be restricted. Of course, with an otherwise uninsurable risk, it is not easy to establish what a fair market premium might be and acceptable to the Revenue as reasonable. Experience suggests that a rate online of 20% is acceptable, but pricing higher than this may attract scrutiny. This effectively suggests that funding for a full loss over a four or five year period is acceptable but funding over three years or less is likely to be challenged. It has to be stressed that it all depends on the circumstances and the evidence available to support the pricing rational.

d) Revenue and audit acceptability

The need for a justifiable premium is essential, as described in the preceding paragraph but the whole arrangement has to be acceptable to the group auditors as well as the Revenue. If all that is being delivered is tax relief on premium or the creation of reserves and there is no real risk transfer, any arrangement will not be accepted as an insurance transaction. It is necessary to look at the risk being insured, the capital, the premium and the structure of the whole arrangement to ensure it can be viewed as a bona fide insurance transaction and is not merely a ‘money box’ arrangement under an insurance guise.

Thus, overall, the limitation of relying on a captive’s own retention is that there is no immediate additional capacity being provided beyond the parent group’s own risk bearing ability, unless reinsurance is arranged. Fortunately, as explained later in this chapter, there are a variety of plans available to increase capacity by way of reinsurance facilities but, without this, the parent might question what it is actually achieving. It might be thought that by starting with low limits, and if there is favourable loss experience then the captive will be able to build up funds and create additional capacity in the future but this organic growth would be a long process and the parent would probably be looking for a more immediate solution. In any case, any need to repatriate profits by way of dividend will militate against this approach.

8.13.6 Financial reinsurance

It is not the purpose here to include a detailed treatise on financial insurance or reinsurance; suffice at this stage to review some basic aspects of this form of reinsurance.

a) What is it?

It can be argued that financial insurance or reinsurance is, for the larger client, little different from conventional insurance. The object of conventional insurance is to spread the losses of the few across the many who insure. By comparison financial reinsurance is the spreading of the losses of one insured over a period of time. The objective is to smooth the impact of potential losses to levels that are acceptable as an expense on the annual profit and loss account and to eliminate unbudgeted losses. For the larger client conventional insurance has the same effect. As has been discussed earlier, premiums paid by larger companies are such that they are only achieving a spreading effect. Reinsurers tend to acknowledge this more than primary insurers and one of the reinsurers' questions when writing a risk might be the period of 'payback' following a major loss. Generally reinsurers look to a ten year payback which tends to be the normal time for a financial reinsurance. All that the financial reinsurance contract is achieving is applying in a contract the risk theory behind the principles of the conventional insurance market. Sometimes financial (re)insurance is known as finite reinsurance in that premium and/or limits and/or the period are finite and agreed at commencement. Whilst this may be so, it can give the wrong impression to Revenue authorities and auditors. The whole basis of an insurance contract is one of uncertainty aimed to cover unknown fortuitous events. Calling a transaction a 'finite' contract at commencement tends to undermine that basic philosophy. An argument could be put forward that the premium might be finite and so might the sum insured. That there could still be a risk element in between is acknowledged but that could equally be said of any other form of insurance where the total insured value is finite for a fixed annual premium.

b) Need for risk elements

Financial reinsurance requires an element of risk transfer to be included. These would be:

(i) Timing risk

Assumptions will be made as to the timing of claims whereas these may occur earlier or later, thus affecting the investment return.

(ii) Investment risk

Apart from the investment risk involved relative to the claims timing, there is the risk of significant changes in the investment returns assumed.

(iii) Credit risk

The underwriter has significant credit risk with their client. They are entering into an arrangement over a period of, say, ten years under which the client is contracted to pay significant premiums each year, possibly dependent upon loss experience. In the event of the insolvency of the client (which might be just the event to occur after a significant loss covered under the reinsurance!) the reinsurer may be unable to recover future premiums due. Insolvency may not be the only thing to trigger such a situation in that a leveraged buyout, leading to the break-up of a group, can have an adverse effect on the recovery potential of reinsurers under a financial reinsurance contract.

(iv) Expense risk

Possibly because of the break-up of the insured group, as described above, or for other reasons such as complicated claims, the expense of operating the plan may be more than assumed at inception.

(v) Underwriting risk

Last but by no means is least the underwriting risk, which has to be significant. Early financial reinsurance contracts had negligible risk transfer which fell afoul of tightening accounting standards. It is now acknowledged that there has to be real underwriting risk contained in the transaction so that a loss could be realised.

c) Accounting/Auditing problems

After the first flurry of financial reinsurance contracts in the late 1980s, changes in accounting standards led to auditors unwinding a number of financial reinsurance contracts, causing a variety of accounting problems and bringing back on to parent balance sheets liabilities thought to have been transferred. It has to be acknowledged that financial reinsurance was miss-sold and or misused by some parties.

There could be a situation where, for example, a company had accumulated significant liabilities on its balance sheet which effectively rendered it insolvent. As an example, this could be an insurance company with adverse loss experience, or a commercial company with an accumulation of workers' compensation claims, product liability claims or product recall expense. What occurred was that these liabilities were packaged and effectively 'sold' to the reinsurance market under a post loss financial reinsurance contract whereby a fixed annual premium was payable over the next ten years equivalent to the value of the liabilities. In effect the company was moving its liabilities off balance sheet and an insolvent company was turned into a solvent company at the cost of securitising the next ten years' income.

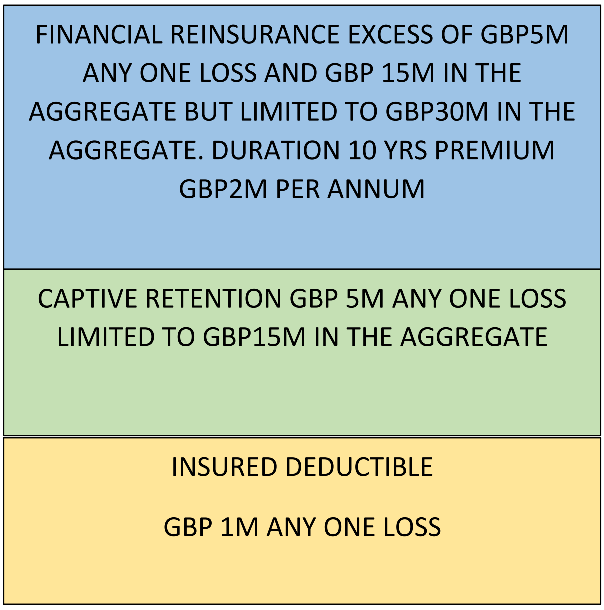
This is known as retrospective risk whereas most insurance contracts relate to prospective risk, i.e. that risk of which we are not yet aware and which may or may not arise in the future.

Naturally auditors were uncomfortable with contracts relating to retrospective risk but unfortunately, the new accounting standards tended to have too broad a brush in effect and considerable difficulties were encountered with perfectly valid reinsurance contracts covering prospective risk falling into the same category as retrospective deals. This was despite the fact that a financial reinsurance contract covering prospective risk can be little different from a traditional contract, except that the ultimate aim of risk spreading over time was overt rather than covert. Any company with an adverse loss experience will be well aware that premiums can be increased dramatically at renewal in order for the insurer to recover claims paid.

Retrospectively rated programmes, where the premium is directly related to losses by means of subsequent adjustments in line with loss experience delivers a guaranteed level of profit to insurers and have been well known for years. Nevertheless, considerable difficulties were encountered under the accounting standards. Hopefully these problems can be resolved by increasing the amounts of underwriting risk in the transaction, but it is good practice that a financial reinsurance contract be carefully structured and the relevant accounting treatment by confirmed by the auditors before completion.

8.13.7 Conclusion

This section started with raising the challenge of how to handle uninsurable risk. The potential inadequacies of the traditional insurance solution have been outlined and these are not solved solely by use of a captive. However, through access to financial reinsurance, an example structure could be developed as below.



The design of the whole programme depends, of course, not only on the amount of risk against which the client requires protection but the amount of cash available to fund it.

This structure has been used as a reinsurance of traditional risks written into a captive. For example, a captive might be writing, say, five different risks each with a maximum liability of £10 million. The chances of all of them incurring a maximum loss in any one year are remote but the captive may have ability to pay only, say, £15 million in total. They might therefore effect financial reinsurance for another £30 million to protect against this (unlikely) worse-case scenario.

Self-test questions

Answering these questions will remind the participant as to what has been learnt. Once completed, please check your answers against the relevant text.

1. How can a fronting company provide a solution to limit a captive's retained exposures?
2. Why is it sometimes better for a captive to take 100% of a risk and then purchase reinsurance as a means to limit its retained exposure?
3. What elements of marine cargo insurance make it an attractive risk for captive participation?
4. What limitations are there on a captive to write uninsurable risks?
5. What key features must exist in any financial reinsurance contract?

Summary of learning outcomes
1. Describe the types of insurance cover typically written by a captive and the ways the captive can participate in these polices.
2. Describe the challenges that a captive can face writing long tail coverages (such as General Liability) and how these can be mitigated.
3. Explain how captives are utilised to respond to risks which the traditional markets have been reluctant to participate.
4. Explain how reinsurance plays an important role in enabling a captive to offer its owner a viable alternative to traditional insurance coverage.
5. Explain how a captive might set about in trying to assist its parent with coverage for uninsurable risks.