Module F Unit 9

INSURANCE POLICY ADMINISTRATION - DIRECT WRITING – FRONTING

Purpose

At the end of this unit the participant should be able to demonstrate an understanding as to what influences the decision of a captive to make use of the services of a fronting company, the additional requirements that fronting entails and the general principles for establishing premiums and policy terms when writing insurance directly.

Assumed knowledge

An understanding of what a captive insurance company is. See Unit 2

Summary of learning outcomes
1. Describe the key reasons why it is often not possible for a captive to write its shareholder organisation's risks on a direct insurance basis.
2. Describe the services a fronting company provide to a captive.
3. Explain the principal clauses of a fronting agreement and the requirements & obligations imposed upon a captive by such an agreement.
4. Demonstrate an understanding of the benefits and burdens of using a fronting company.

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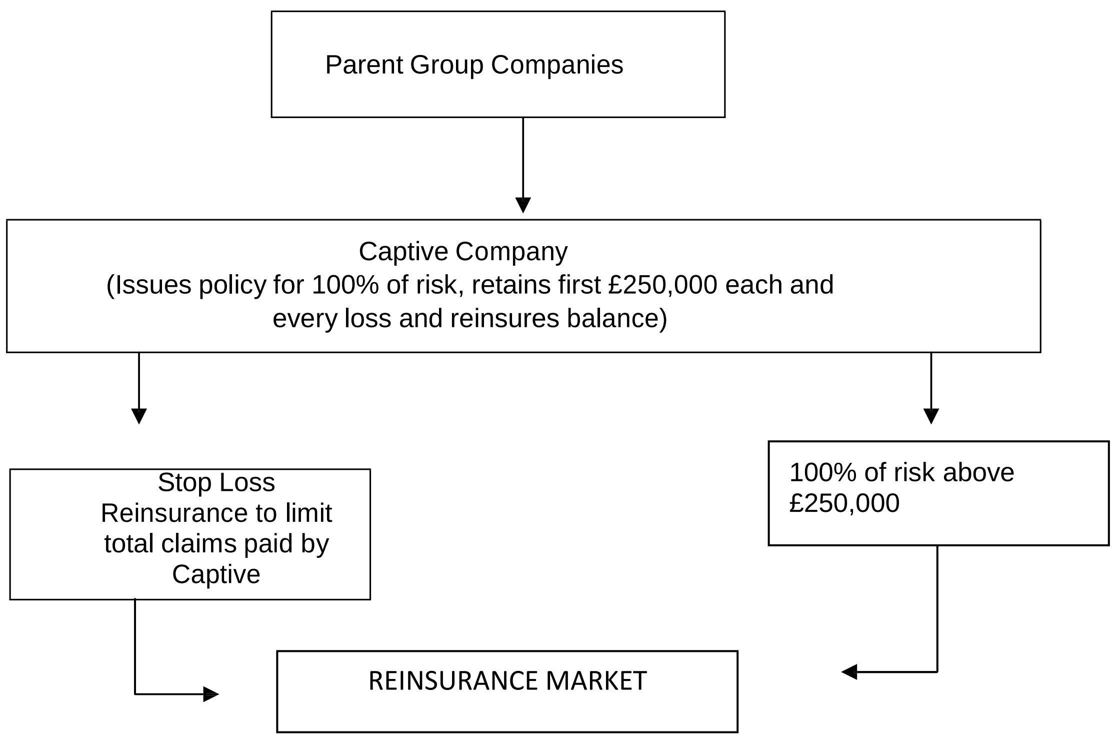
INSURANCE POLICY ADMINISTRATION - DIRECT WRITING – FRONTING

9.0 DIRECT WRITING

A captive can write business direct with the parent group, in which case it is operating just like any other primary insurer or it can write as a reinsurer where, generally it will act as the principal reinsurer of a local fronting company, as discussed in more detail later. The captive can, indeed, also write as a straight reinsurer, possibly sharing in a reinsurance treaty along with other reinsurers or it can write as a retrocessionaire where there is a reinsurer between the primary insurer and the captive.

In certain countries, local law demands that all insurances are placed with an insurer licensed in that territory and therefore it is generally not possible for a captive, usually domiciled outside of that territory and in an offshore location, to write business direct. It is relatively straightforward to write non-compulsory risks direct from the USA although there may be a penalty of Federal Excise Tax on the exported premium. For those domiciles that have full European Union membership, captives established in those domiciles have the ability to write direct throughout the European Union and European Economic Area, and thus are able to dispense with the need for fronting insurers and potentially avoid fronting and collateral costs. Thus, it is not uncommon to see an EU domiciled captive writing business on a direct basis whereas most other captives would write as reinsurers of a primary company. In practice, most captives write as reinsurers, wholly or in part, as even when some of the business can be written direct, it may be administratively more convenient to have a standard fronted programme

9.0.1 Flow of Risk – Direct Policy



INSURANCE POLICY ADMINISTRATION - DIRECT WRITING – FRONTING

The above diagram is an example of a direct writing captive showing the flow of risk and premium between the parent group, its captive and its reinsurers. The captive will have a direct contractual relationship with the parent group companies. It will be the primary underwriter and will issue a policy directly to the parent group and subsidiaries for the risks it writes. The captive will then typically reinsure the risk in excess of its retention, probably on an excess of loss basis with an aggregate stop loss to protect from a multiplicity of losses in any single year.

Where risks are written on a direct basis, three main aspects need to be addressed and considered:

9.0.2 Rate setting

- Initially the captive might write traditional business adopting the existing rates, or a comparable quotation received for renewal, and then, possibly, discount these rates on the grounds that the captive will have a lower combined ratio.

- The initial rates will then be developed on the basis of loss experience and varying risk factors. Just like any other traditional insurer, the captive will adjust its premium in accordance with loss history; if losses go up so will the premium. Equally, premiums may come down with an improved loss experience. Naturally the initial result of good loss experience will to be to improve the captive's profit and subsequently this can be reflected in renewal rate reductions. The rates may also change in accordance with risk factors and, writing on a direct basis, it is possible for the risk manager to introduce various incentive schemes for the implementation of better risk management in the subsidiaries and the captive to recognise this expenditure on risk management by incorporating rate reductions into the insurance premiums. Direct writing with such incentive programmes can be a great aid to the development of superior risk management within the parent group.

Reinsurers' expectations are also a factor in the rating. Reinsurers will require a certain premium, which may be a fixed amount or a percentage of the incoming premium and the captive has to be left with sufficient funds to meet its expenses and potential losses. If reinsurers determine that the primary rate is too low they can suggest this be adjusted or will price their risk adopting the rating they have recommended thereby squeezing the funds held by the captive to cover its retained risk.

Where the cover being written is not traditional and possibly there is no comparable market rate, the rate charged has to be credible and defensible. A ratio of premium to risk of 20%, i.e. a maximum loss every 5 years can be acceptable but a rate much above 25% might be scrutinised, although may still be acceptable in certain circumstances. The key is to be able to demonstrate a credible pricing methodology and an audit trail as to how the pricing decision was made.

9.0.3 Policy wordings

It may be thought that writing on a direct basis allows greater flexibility in policy wordings and that these can be much wider than the conventional market might offer. Whilst this can be true, policy limitations imposed by the market usually are based on solid reasons and before writing back exclusions, the captive needs to consider the extra risks involved and the premium that might be required to insure those risks. Reinsurance issues have to be considered as, for consistency of cover and the avoidance of gaps, the reinsurance contract wording needs to follow the primary contract. Clearly this cannot happen if the extended cover is unacceptable to the reinsurers. Having said that it is possible to issue more straightforward policies, possibly with extensions, albeit that in some cases the extended cover has sub limits such that they remain within the captive retention and do not involve reinsurers.

The administration of the policy can be much simpler. Adjustments to sums insured can be updated annually, if at all. Premiums could be paid in installments or a long credit period offered and whilst this will obviously impact the investment earnings of the captive, it may be to the overall advantage of the parent group. All of these administrative improvements may be possible with a traditional policy but there are variabilities between insurers as to how accommodating they will be and there would certainly be more scope for a captive to provide the flexibility required by the insured.

Finally, the policy wordings should dovetail with fronted programmes. A lot of captive programmes have business from some countries written direct and from others under a fronting arrangement, whereas part of these risks, when combined in the captive, will be contained in the same reinsurance programme. It obviously makes sense that these covers are as similar as possible and ideally the insured's risk manager would be looking for commonality of policy wording throughout the group. Thus, the upshot might be improvements in the fronted policies as much as the direct policies to arrive at common terms.

9.1 ROLE OF FRONTING

Probably the main reason for a fronted programme is because the captive wants to write business from those territories where the subsidiary is required by local legislation to buy its insurance from a locally licensed and admitted insurer. There are a number of websites where the legislation and regulation relating to the writing direct insurance in various territories can be found. Please see . https://www.axcoinfo.com/products/compliance-point/ as an example of one such site. Usually there are no similar restrictions on reinsurance (although a few territories such as Brazil require the reinsurer to be admitted too) so that the local insurance company is free to reinsure with the captive. Occasionally there may be a need for a licensed reinsurer to be placed between the primary insurer and the captive but this is not common albeit it is relatively straightforward to arrange but incurs additional expense.

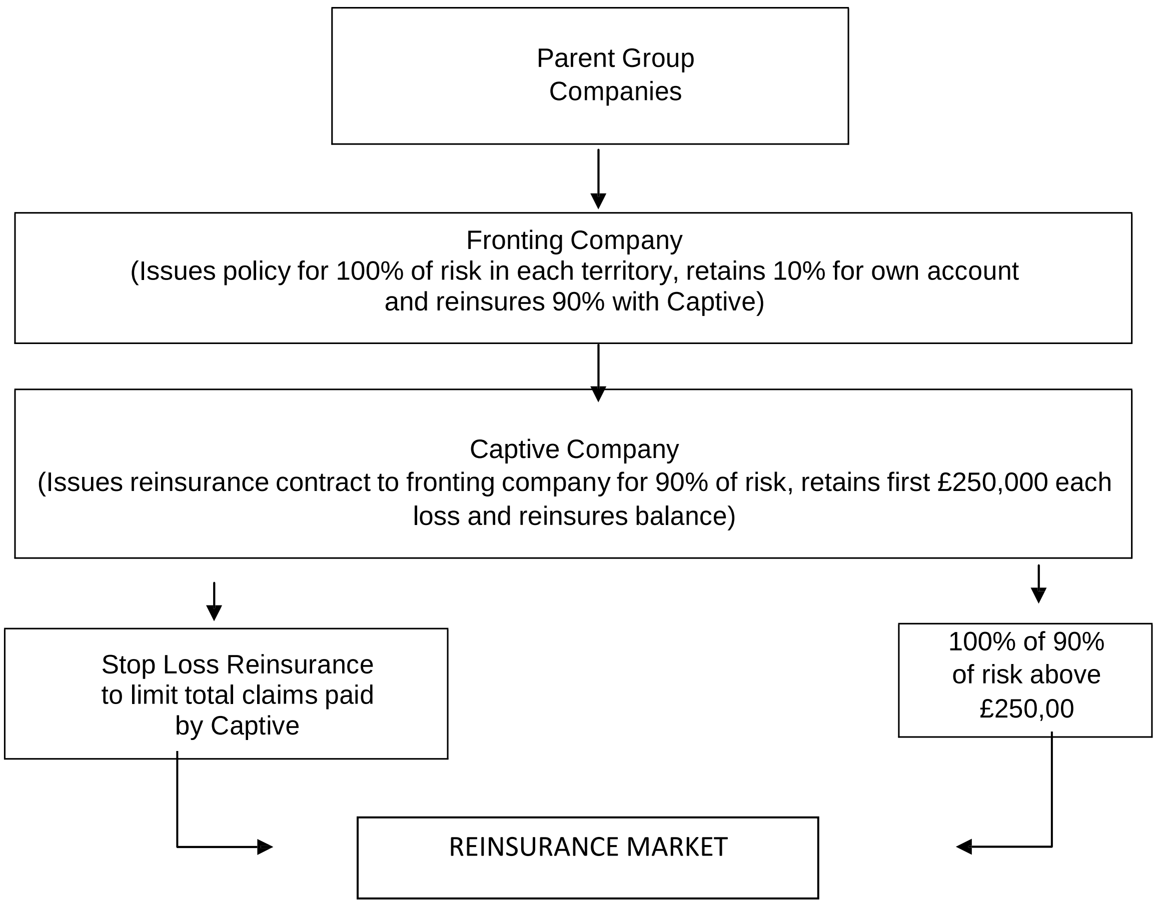
Other reasons for fronting can be the presence of debentures, banking covenants or conditions under loan agreements or leases taken out by the insured parent or its subsidiaries. Even though there is no legal restraint on UK companies insuring non-compulsory covers directly with a captive, the parent may have loan agreements requiring that the assets, which are the security for the loan, are insured with an insurer acceptable to the trustees (and typically with an acceptable credit rating). A captive is usually acceptable security There is no incentive for the holders of debentures or banking covenants to agree to the participation of any insurance company that is not licensed in their country and for which they cannot easy check the security. Equally where a company is leasing its premises under an agreement where they are also responsible for securing insurance, a captive is unlikely to be acceptable to the building owners. In these circumstances a fronting arrangement solves the problem as the captive is in the background and the fronting insurer is the primary insurer regarded by the parties as carrying all of the risk and responsible for the performance of the insurance contract.

A parent may also want to arrange fronting purely for convenience. With a world-wide group, much of the programme will have to be fronted due to local regulatory restrictions and the parent may consider the administrative convenience of including all territories which they could otherwise insure directly, within the fronted programme as outweighing some marginal cost saving. This avoids having to issue multiple policies, and overcomes the problems of dovetailing direct and fronted programmes. It may enable a better deal to be negotiated, given the economies of scale where it is all placed with one single global insurer.

Usually, it is advisable to choose a single global insurance group as a fronting company. This enables the risk manager to negotiate directly with the global programmes team of the insurer on behalf of all of his group subsidiaries, bearing in mind that in these negotiations he would be taking the role of the global risk manager arranging the primary insurance placement for his subsidiaries and not in the role of captive insurance company director arranging the reinsurance. Obviously as part of the programme design, it is agreed with the insurer that an offer to cede an agreed percentage, say 90%, of the risk will be made to the captive insurance company. This is an attractive arrangement to a single insurer is it is accumulating a large block of business and even a 10% risk retention is meaningful. Sometimes such a global arrangement is not possible either because of the lack of representation of an acceptable global insurer in the countries in which the insured is operating or because of the size of the subsidiaries and the long standing connections they have developed with local insurers. In these cases separate negotiations may have to take place with a number of local companies which becomes administratively expensive for the captive and may involve higher fronting costs in that no one fronting company has a sufficient economies of scale to enable the risk manager to secure the best deal. However, not getting the best financial deal may well be preferable to not securing the deal at all which may be the result if the alternative is an insistence that only one global insurer is used thus alienating the subsidiary.

9.1.1 Reinsurance captive

Flow of Risk – Fronted Policy
(Captive acts as Reinsurer of Local Direct Company)



The above example shows the flow of risk where the captive acts as the reinsurer of a local direct (fronting) company. What has happened, effectively, is that the fronting company has been inserted between the parent group and the captive. The fronting company will retain a proportion of the risk for its own account, commonly +/-10%, and reinsure the balance with the captive. The captive is then only receiving 90% of the initial risk but its reinsurance programme will be similar to that under the direct policy and, indeed, many reinsurance programmes include both fronted and direct business. What does differ dramatically under a fronted programme, are the contractual relationships between the various parties. As will readily be seen, the captive no longer has any contractual or legal relationships (insofar as insurance or reinsurance contracts are concerned) with the parent group. Its only contracts are with the fronting company which means the fronting company is 100% liable to the parent group and dependent upon its reinsurer, the captive, for recovery of 90% of each claim. It is inadvisable for the fronting company to issue a primary policy limited to its own retention and/or subject to collection from its reinsurer, i.e. the captive. This would not happen in the traditional market and if it is written under a captive arrangement, it undermines the whole contract with the associated fiscal ramifications. Thus, as discussed later, the fronting company is reliant upon the captive's ability to pay.

9.2 FRONTING FEES

What is commonly known as a fronting fee i.e., the fee paid by the captive to the fronting company for their services, is, in reality, a ceding commission between the primary insurer and its reinsurer, i.e., the captive. The normal range of fronting fees for a property account is between 5% and 7% but it is not uncommon for it to vary above and below this figure according to the class of insurance, the size of the programme and the amount of work required to be undertaken the fronting company. For a large global programme where much of the service is carried out by the manager or group brokers, a fronting fee in the range of 3% to 5% might be agreed. Where a global broker carries out most of the work but the programme is placed piecemeal with different local companies, the fee may be in the range 6% to 8%. In those cases where the fronting company is also expected to provide local service and possibly loss prevention and safety engineering services, fronting fees of 8% to 12% may be seen. For some liability programmes, where there might be a high level of claims activity, a fronting fee of 15% to 20% may be realistic.

The objective is to reimburse on a fair basis the fronting company for the work that it is performing on behalf of the captive. Only the risk manager and the captive manager will know the extent of this work and what it is worth. Obviously, it is important to ensure that neither the fronting company nor the captive is duplicating work but the labourer is worthy of his hire. Rather than just agree a percentage initially, it can often be a good practice to discuss the services required and the associated costs that the fronting company will be assuming and then either convert this to a percentage of premium or agree a fixed sum for this work. Both sides need to be satisfied; the insurers need to be properly rewarded for their work and the captive needs to be comfortable it is receiving value for money.

In addition to the work undertaken by the fronting company, it will include a charge, within the fronting fee, relating to the cost of capital charge it incurs for ceding risk to an unrated reinsurer i.e. the captive. The level of capital charge may be modified if the captive is rated at investment grade, and rating of captives is becoming more common. Alternately the cost of capital charge can be eliminated by the captive posting acceptable security to act as collateral for the reinsurance by way of a Letter of Credit or Security Interest Agreement.

9.3 FRONTING REINSURANCE AGREEMENT

The fronting agreement is in the form of a reinsurance contract between the primary insurer and the captive. Contractual obligations should not be assumed or left to an exchange of correspondence. Care is required in the construction of all contracts and reinsurance contracts, which can be expected to run for many years, are no exception. If the original intent of the agreement is to be achieved and maintained, surviving changes of staff at both entities, it is essential it be committed in the form of a proper written reinsurance agreement, signed by both parties.

A draft sample agreement is included in the Appendices. It is stressed that this is only one example and they do vary according to the fronting insurer and the type of insurance risk being fronted. The example contains all of the typical clauses found and you should therefore read this document and seek to gain an understanding of the importance and impact of the clauses it contains.

9.4 SECURITY FOR THE FRONTING COMPANY

As stated above, despite the fact that the fronting company may be reinsuring 90% of the risk with the captive, it remains responsible for 100% of the risk to its original insured. Whilst this may be similar to a traditional situation, where a company might reinsure, the difference lies in the fact that with a captive arrangement, the reinsurance is with a single company and probably in an offshore domicile. Comfort with the captive's participation may be considered high in that the insurer will be aware of the activities of the client group and should be satisfied as to the financial strength, but this may not be sufficient. The captive is an entirely separate subsidiary and there can certainly be no guarantee that it will be supported by the parent should it get into financial difficulties. Those difficulties could come from the captive writing lines of insurance totally unconnected to that with which the fronting company is involved or by the failure of some of the captive's reinsurance facilities. Problems have arisen from the practice of leveraged buyouts of companies where they are subsequently asset stripped, disbanded and parts sold off. The captive of such a group remains responsible for whatever insurances it was writing but its parent group may no longer exist and neither may some of the subsidiaries which were its clients. A fronting company or, indeed, a reinsurer relying on loss related premium adjustments, may find themselves in difficulty as the captive may be unable to obtain a required premium adjustment and thus be unable to pass it on. There are all sorts of reasons which could cause difficulties for the fronting company seeking to recover funds from the captive. Having said that, whilst losses arising from captives failures to fronting companies have been negligible losses suffered by ceding companies from traditional reinsurers going bankrupt have been more material.

In an attempt to eliminate this security risk it is quite normal for a fronting company to seek some additional security.

9.4.1 Parental guarantees

The first thing a fronting company might ask for is an irrevocable guarantee from the parent to stand behind the captive and to meet all of its obligations in the event the captive is unable to do so. This is typically unacceptable in that it undermines the separate arm's length nature of the captive. The captive should be adequately capitalised and able to operate as a bona fide insurance company. All of that would be weakened by the existence of a parental guarantee to the extent that the captive could be considered a part of the parent and the reinsurance placed with the captive a sham. Such a guarantee might also have to be stated as a contingent liability in the parent's financial accounts – something it probably would want to avoid. Further, the fronting insurer would be assuming the credit default risk of the insured.

9.4.2 Hold harmless agreement

As an alternative to the full parental guarantee, the fronting company may ask for a hold harmless agreement but this is really the same commitment in different guise. Instead of an agreement to stand behind and fully guarantee the captive the insurer is asking for a guarantee that the fronting company will be held harmless by the parent for any losses they may suffer as a result of the captive not being able to meet its obligations. This is normally equally unacceptable.

9.4.3 Pay as paid clause

The insurer may want to include a clause in the insurance policy stating that they will only pay a claim when reimbursed by the reinsurer, being the captive. How legally valid this is as between a subsidiary and a local fronting insurer, is open to question but, that apart, this would not be a normal clause in a traditional policy, may be unacceptable to the local regulator, may be unenforceable and undermines the bona fide nature of the captive and, indeed, of the whole transaction. Again, this is unlikely to be an acceptable form of security

9.4.4 Cut through clauses

The fronting insurer may well have asked for details of the captive's reinsurance programme. The insurer will be aware of the limited risk retention of the captive and therefore want to ensure that the reinsurers with whom the captive is buying protection would be equally acceptable to itself. But comfort as to the security of the captive's reinsurers may not be enough because the flow of claims reimbursements would be from the reinsurers to the captive and if the captive was insolvent, the liquidator may not permit the same amount of money to flow through from the captive to the fronting insurer. Any receipt would merely form part of the overall funds for eventual distribution to creditors. Therefore, the insurer may seek a cut through clause whereby the fronting company can interact directly with the reinsurance of the captive. The aim is to create a contractual relationship between the reinsurers of the captive and the fronting company. The efficacy and the legality of such clauses are open to debate but one thing for certain is that they should never be made subject to the insolvency of the captive. A cut through clause which starts, "in the event of the insolvency of the captive the fronting company has access to the reinsurers and can recover as would the captive", would not work because this clause is committing a potential liquidator before such a liquidator is appointed. It would be invalid because the operation of the clause can only be after the captive becomes insolvent whereas that is exactly the time that the board, who agreed to the clause, are no longer in control of the captive. Far better is a clause which permits the cut through under any circumstances so that the fronting company can cut through at any time. Whether they do or not is immaterial provided that is how the clause is worded. Whilst this clause may give comfort, its efficacy has been challenged successfully in courts and so again this is unlikely to be an acceptable security solution.

9.4.5 Security interest agreements

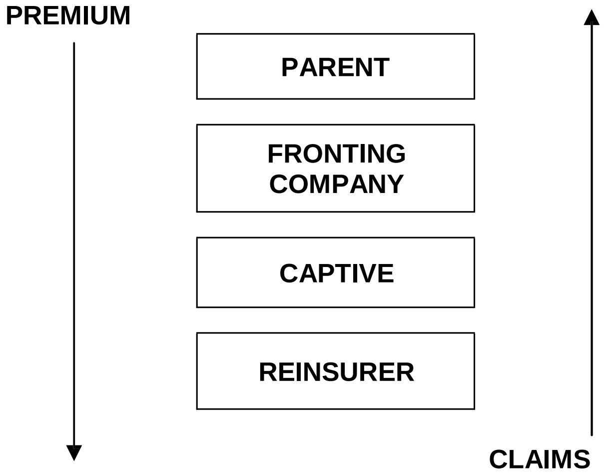
Increased demand for collateral has led to the increased use of security interest agreements and security trusts (SIA) as viable alternatives for the provision of security in domiciles which have legislation enabling their use. Funds equivalent to unearned premiums and any loss reserve amounts are paid into a security trust or fund which is administered by a trustee or custodian. Captive funds can be invested in accordance with agreed conservative investment guidelines which are agreed with the fronting insurer, enabling a reasonable investment return, In the event of the captive not meeting its obligations in respect to claims reimbursements to the fronting insurer, the insurer can instruct the trustee to pay claims from the security fund. Once all contractual liabilities have been settled any excess funds can be released to the captive. Usually the cost for such arrangements is cheaper than for a letter of credit.

9.4.6 Letters of credit

The preferred method of obtaining security from captives for most fronting insurers is through the use of letters of credit (LOC). These are provided to fronting insurers on behalf of captives by banks and are usually secured against cash deposited at the bank by the captive. The amounts demanded by the fronting insurer are usually the sum of unearned premium and claim reserves, both case reserves and IBNR. The level of security provided is reviewed annually as liabilities may start stacking and claims payments need to be funded from other sources of cash.

Letter of credit can an expensive option. The bank providing the LOC will often also hold the captive's cash, often offering low or no interest rates and the banks typically charge a % of the value of the LOC as an administration cost. This charge is often significantly higher than the charges involved for a SIA. However, due to its universal acceptability, a LOC is the most popular form of security.

9.5 FRONTING SECURITY FOR THE INSURED



The above shows the premium flow from the parent through the fronting company and captive to the ultimate reinsurer. When claim payments are required they will follow the reverse route from the reinsurer and these must go through the fronting company to the parent and could be lost in the event of a liquidation of the fronting company. The captive cannot exclude the fronting company and pay its parent group direct because it doesn't have any contractual relationship with the insured. Indeed, if it does pay direct, it may still be called upon to meet its obligations to the fronting company by the fronting company's liquidators. Thus a full payment may be made by the captive, having recovered from its reinsurers but that full payment may not necessarily be passed through to the parent group: the parent group will only receive the same proportion of any lodged claim in a liquidation as will any other creditors. There is no complete answer to this problem but some protection can be obtained. First, the captive has to be satisfied with the stability and rating of the fronting company and keep this under review. Secondly, the third paragraph of the Insolvency Clause, Article XIX in the draft agreement at the end of this chapter, states that if the fronting company becomes insolvent, the captive can pay the original insured direct. How valid this would be remains to be tested. It is better than nothing but could this be considered as giving one creditor preference over another? What about payments when the company is in difficulty but before official insolvency triggering the clause? Finally, some jurisdictions have enacted consumer protection laws that protect insureds in the event of an insurer failure. The insured is able to "look through" the insurer and access any reinsurance protection the insurer may have had in place.

The problem is very much greater with long tail business because even constant monitoring of the security of the fronting company does not avoid the situation of a claims tail. Ceasing the arrangement today does not necessarily avoid the risk of claims which may not even arise, let alone be settled, for many years into the future.

INSURANCE POLICY ADMINISTRATION - DIRECT WRITING – FRONTING

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. Why do fronting companies require security from a captive? 2. Why is a parental guarantee typically not an appropriate solution by which to offer security to the fronting company? 3. Provide two reasons why it may not be possible for a captive to write insurance directly? 4. Name two reasons why care must be taken when determining the premium and policy terms for a policy written directly with the captive shareholder organisation? 5. It is recommended you read the sample Fronting Agreement provided in the appendices

Summary of learning outcomes
1. Describe the key reasons why it is often not possible for a captive to write its shareholder organisation's risks on a direct insurance basis.
2. Describe the services a fronting company provide to a captive.
3. Explain the principal clauses of a fronting agreement and the requirements & obligations imposed upon a captive by such an agreement.
4. Demonstrate an understanding of the benefits and burdens of using a fronting company.