

Focus on captives

Businesses sharpen their focus on captives during global economic crisis, says Michael Serricchio of Marsh Captive Solutions

AS THE GLOBAL FINANCIAL crisis of 2008 unfolded, businesses around the world became increasingly focused on their strategies for managing risk and many began exploring alternatives to their existing insurance and risk transfer arrangements. In some instances, captives are taking on broader roles as part of a company's overall risk management strategy.

Is more retention more risk, or less?

In the wake of the worldwide economic recession, corporate risk managers must manage their firm's exposures with lower budgets. At the same time, treasurers and CFOs want to conserve, as well as access, cash while reducing letter of credit requirements. Also, captive owners are assessing current programme structures to optimise cost efficiencies.

In these conditions, businesses that use captive insurers as part of their overall risk-management strategy tend to have more budget flexibility and negotiating opportunities when it is time for renewal with the insurance markets. For example, captive owners can save money in challenging economic times and during hard insurance markets if they insure risks within their captives – by raising self-insured retentions and, as a consequence, possibly increasing the likelihood of obtaining premium credit from commercial insurers. If a company determines that it can assume additional risk and purchase reduced amounts of insurance from the commercial insur-

ance market, it may choose to insure its increased retention through its captive. Depending on the cost of insurance and how effectively the self-insured risk is managed, businesses using these approaches can achieve significant cost savings.

The reinsurance stage

Companies that own captives generally have a distinct advantage of being able to access reinsurance for risks that are normally only insurable through commercial carriers or that are cost prohibitive. For example, US domestic captives can write some forms of terrorism insurance, and specifically nuclear, biological, chemical, and radiological (NBCR) and obtain federal government backstop through the Terrorism Risk Insurance Act (TRIA) of 2002 and the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) of 2007. Other global terrorism pools are also available to captives.

In this example, a company with low loss history that has determined it can use its captive to self-insure up to \$50m for products liability risk, may be able to obtain reinsurance for limits in excess of \$50m at a lower cost than might be required to purchase primary coverage using a high-deductible policy. It is important, however, that insurance buyers monitor the credit quality of the reinsurance industry in light of current economic conditions.

Some companies that access reinsurance directly may have concerns about the



financial viability of their reinsurers, in particular their ability to remain solvent well into the future when long-tail claims will need to be paid. In these cases, the companies might consider self-funding some of the risk they have ceded to the reinsurance markets or examining alternative markets. These companies may be able to reduce the pro-rata amount of reinsurance they purchase by retaining some of the risk within their captives, thus restricting corporate dependency on reinsurers.

The domicile scene

New and emerging domiciles may pave the way for more captive formations in 2009, as competition increases between existing and emerging domiciles and more companies seek alternative risk-financing solutions. For example, consider the competitive environment in the European Union (EU), particularly among the Dublin, Gibraltar, Luxembourg, and Malta domiciles.

Many businesses consider Malta to be an expanding domicile in the EU because of its quick formation time for new captives, regulatory flexibility, and the availability of lower-cost service providers. A company that decides to form a captive based on



the current economic conditions, but is up against a challenging renewal time frame, may benefit from a domicile that allows quick formation.

In EU domiciles, clients that direct-write can benefit from cost savings because they are able to eliminate fronting fees across the EU. If a company has a significant presence and inherent risks across the EU, the direct writing option may save the organisations hundreds of thousands of dollars in commercial fronting fees which, in many cases, is pure profit and administrative fees, charged by commercial insurers.

In the Middle East, the Dubai Financial Services Authority (DFSA) recently sanctioned captives to be formed in Dubai – as significant growth is expected across this region in the future. Companies based in the Middle East may find Dubai an attractive domicile based on its favourable tax environment, similarity to other international captive laws, accessibility, and time zone.

In North America, Connecticut will be the latest 'new' US domestic domicile to allow captive formation, allowing captives based in other global domiciles to merge into a new Connecticut captive. Other US states may follow.

Companies may look at new domiciles that offer lower cost vendor fees, or no premium tax jurisdictions, such as Arizona and Utah. For example, Connecticut, like Hawaii, has no premium tax on reinsured premiums, which could result in substantial savings for companies that assume fronted reinsurance. Companies that currently have and operate multiple captives may wish to merge and consolidate their captives, which may help reduce operating costs and overhead. In some cases, consolidating two captives can save a company approximately \$75,000 to \$250,000 based on the captives' operations and domiciles.

More captives obtain ratings

In addition to companies taking on larger retentions for premium credit, and looking for ways to reduce their dependency on commercial carriers, captives have increasingly elected to obtain credit ratings. In recent months, more captive insurance companies and risk-retention groups have requested A.M. Best, S&P, or Moody's

ratings. Captive owners typically want or need a rating to satisfy requirements of certificate holders or lenders; to meet contractual requirements, or to address internal needs, such as demonstrating to management that the captive is as viable as a commercial insurer with the same objective "B+ or A- rating."

The growing number of captives obtaining ratings may also signal that organisations with captives are assuming more risk and need rated paper to satisfy their certificate holders. In some instances, captives may be providing or participating in coverages or limits that had been insured through commercial carriers.

Optimising and investing

Captive owners are constantly monitoring whether their captives are being optimised, and whether they continue to be relevant in the current economic and insurance environment. Depending on the needs and resources of their companies, owners can examine their captives' financials to determine if there is excess surplus that might be invested at the intercompany level as a mechanism to return cash to the parent.

Captive owners must be vigilant about making sure their captives are adequately capitalised. In addition to meeting regulatory requirements for solvency and liquidity, captives need to be sufficiently capitalised to carry out their business plans and to remain economically viable in the event of a catastrophic loss. Parent companies should routinely review the captive's policy terms, limits, loss experience, and loss projections to determine whether there are sufficient cash assets and capital to pay claims, both for 'working losses' and potential catastrophic events.

However, captives with 'trapped cash' may be able to identify opportunities to participate in such intercompany investments as accounts receivables or trade receivables factoring, leases, investment in fleets of vehicles or machinery, secured loans, and mortgages. By entering into these investments, cash at the captive that is not being used to pay immediate or short-term future claims can be returned through a regulatory approved transaction. Furthermore, captives with excess

capital can make dividends to the parent company. If the captive is a wholly owned subsidiary, a dividend received deduction (DRD) may provide for a tax-free dividend. Captive owners need to check with their tax advisors on such matters.

Third-party business

A growing number of businesses are exploring opportunities to insure unrelated third-party business through their captives. The reasons driving this trend include: (1) A certain amount of third-party business can help qualify a captive as an insurance company for federal income tax purposes; and (2) Third-party business can be used as a profit centre approach for companies. Many companies need to provide insurance to small independent contractors, franchisees, customers, and distributors. Issuing their insurance through a captive helps enable a company to keep its suppliers, customers, transporters, and vendors in business so that the company remains profitable.

In conclusion

Captive insurance companies, whether already owned and operated or being planned or contemplated by a company examining its risk-management initiatives, can be viewed as vehicles that have the potential to help a company navigate through periods of economic stress. Captives may be used as mechanisms to reduce costs, save premium dollars, improve access to commercial insurance capacity, realise potential tax benefits, and return trapped cash from within an existing captive to the parent company.

In addition to potential economic benefits, captives can help to facilitate a more disciplined approach to enterprise risk management. This may be accomplished through the rigor of having premiums allocated, the need for better cost accounting for risk, and by having oversight of the risk-management process by domicile regulators, auditors and actuaries on an annual basis.

Even in a downturn economy, companies are forming captives for cost savings, risk-management benefits, and to offer insurance to third parties. In some instances, companies with captives are streamlining them by merging their multiple captives. Others are choosing to expand their existing or dormant captive, re-domiciling them, and assessing their captives for additional operational efficiencies.

As captives begin to take hold in more regions of the world, they are maintaining their status as an integral element of corporate risk financing strategies. Today, they are increasingly viewed as long-term solutions that can provide their owners with sound business, operational, and financial efficiencies.

By Michael Serricchio, vice-president, Captive Solutions Marsh.