CAPTIVA
INSURANCE MANAGERS

REPORT

Risk Management & Captives

Are you a risk manager without a captive?

I'm often surprised how rarely "risk manager" and "captive insurance" appear in the same sentence, and this has led me to question how many risk managers have a captive insurance company? I'd like to think that every company that owns a captive also employs a risk manager, but I wonder how many risk managers are employed by companies that don't own their own captive?

Quite often being a risk manager is a pretty thankless task. You work hard, know more about the company than anyone else, have excellent relationships with most of your colleagues, but still when you meet with senior management you sometimes feel that you're treated indifferently.

In some companies the risk management department is even considered to be a drain on resources. Because the department doesn't generate any revenue income for the organisation, it is sometimes overlooked and left out of the company's strategic planning process. All managers know that communication within an organisation is essential to its overall well being, and especially when trying to engender a healthy risk management culture.

As long as risk management is seen as an unwelcome expense and a burden to an organisation, it's going to be difficult for the risk manager to get the attention he deserves from others in the group. Although things have improved markedly over the past twenty years,

revenue producing divisions such as sales and marketing may still be seen to be more important than risk management to the detriment of the overall risk management process.

One way to help address the imbalance is to link the work that the risk management department does to some sort of cost-of-risk financial measure so that others can clearly see the financial benefits of risk management. There is no better way of achieving this than by your company having its own captive insurance company.

A captive can be the window or the show-piece of the risk management department. A well organised and managed captive that is under-pinned by a robust risk management process will make profits. Those profits represent tangible proof that the risk management can save the parent company money and be a profit centre in its own right.

The alternative forms of risk financing such as captive insurance now available in the market are numerous. Long gone are the days when only very large publically quoted companies could justify having their own captives. There is now any amount of self-financing facilities available to mid-sized organisations. Depending upon the jurisdiction of the parent, mid-sized companies can set up their own pure captives or enter some sort of renting agreement which allows them to insure their own risk but without the problems of having to incorporate and direct their own insurance company. The fact is that there are now many different ways a company can get insurance protection instead of being totally dependent on the traditional insurance market.

These captive alternatives and where they can be domiciled are well known, so I do not intend to go into detail explaining them all. Instead, I'll get straight to the point and concentrate on the advantages of owning your own captive or participating in a captive facility of some sort.

First of all, who should have a captive? As long as your company has an excellent risk management system in place, has claims consistently lower than premiums and is willing to take a controlled amount of risk, then it is worth investigating.

The advantages of having your own captive include:

1. **Reduced reliance on the traditional insurance market**
   As the captive matures, its surplus grows allowing it to retain more risk, and not be so dependent upon the traditional insurance market.

2. **Reduction of the costs of insurance**
   The price of insurance coverage purchased in the conventional market typically includes insurers' acquisition costs such as marketing and broker commissions, administration and overheads as well as profit to the insurers. Although establishing a captive cannot eliminate these costs, it can reduce them. A traditional insurance company may have operating costs of over 30%, whereas a captive would hope to operate at less than 10% of premium.

3. **Stabilisation of premiums**
   Having premiums based on your own claims experience provides a stable and predictable scenario for financial planning, whereas being reliant on the insurance market makes you vulnerable to the fluctuations of the general insurance market. In other words, having a captive means that you don't have to pay for other companies' losses by way of higher annual rates.

4. **Provision of cover which is otherwise unavailable**
   The conventional market may be unwilling or unable to provide cover for certain risks. The establishment of a captive enables the insured to insure risk that would be otherwise uninsurable.

Captives are often used to fill gaps in market policies by providing Difference In Conditions or Difference In Limits coverage. Also many specialist reinsurers are happy to attach at a level that allows the "uninsurable" area to be financed and priced by the Captive.

5. **Access to the reinsurance market**
   Because reinsurers generally only deal with insurance companies, a captive affords direct access to the international reinsurance markets which may result in lower rates.   For larger captives in particular this allows them to benefit from catastrophe insurance layers priced and structured by Cat Underwriters.

6. **Control of overall excess premiums**
   As excess layer pricing is normally predicated on the "primary layer rates" when you insure the primary through your Captive (at a proper price) you can begin to influence the XS Underwriters pricing.

7. **Reduction of government regulations and interference**
   By contrast to the rigorous insurance regulation in most industrialised countries, a domicile can sometime provide a less onerous, yet responsible, regulatory framework permitting the captive to grow and prosper.

8. **Formalisation of the allocation of deductibles for Self-Insurance retention within a group**
   A captive gives the risk manager greater flexibility to allocate premiums and profits to different parts of the group.

9. **Underwriting and risk management benefits**
   A key advantage of a captive is its ability to provide risk management information across a spectrum of disciplines. Having a captive makes the collection and analysis of data easy for the risk manager who can clearly see how claims reserves have been calculated.

10. **Opportunities for improved claims handling and control**
    A captive is also free to establish its own claims handling policies and procedures. This has obvious advantages such as the reduction of the time taken to process and pay claims.

11. **Tax advantages**
    While professional tax advice should be sought before making the decision to form a captive, there are likely to be certain tax advantages associated with having a captive. These might include the accumulation of underwriting and investment income on a tax-free basis, and the deductibility of premiums paid for by the insured as a business expense.

12. **Improved cash flow**
    The ability of a captive to generate investment income from unearned premiums received is often a critical advantage in forming a captive. This is especially so where premiums are paid in advance. In addition to premiums, there are also significant cash flow benefits on loss reserves which are paid out over a lengthy period of time.   These will all generate investment income for the captive and parent rather than the insurers.

13. **Ability to direct investment options**
    Generally, when you purchase commercial insurance you do not control the investment of the premiums. The directors of a captive will have the opportunity to direct these investment choices.

14. **Creation of a profit centre**
    Any insurance company with premiums greater than claims and expenses will be profitable. A captive with tighter control of premiums, claims and expenses will be more profitable. Most importantly, it also focuses the senior management on the results of good loss prevention, and results in stronger support for risk management initiatives and the establishment of risk management objectives for operational management all of which acts to improve the risk profile and reduce the cost of insurance.

The last three points are the most important to the rest of the organisation. To be responsible for a revenue stream with control of investments and cash flow is a huge attraction to any group treasurer, and should help raise the profile of the captive within the total group.

A captive shows in financial terms that a good risk management process not only directly helps improve efficiency by controlling risks and avoiding interruptions, but can also generate profit. This strengthens the risk manager's hand when he wants the company to invest in new risk management initiatives such as appointing an external risk engineer to assess a new risk, purchasing new safety equipment or providing risk management training for staff. If senior management is able to see a tangible and quantifiable financial return from risk management through a captive, it is far more likely to approve new risk management initiatives. A captive is an excellent way to reduce an organisation's total cost-of-risk.

I always encourage the owners of the captives that I manage to allocate a portion of their captive's profits to the risk management department. These funds can then be allocated throughout the parent group. Control over a pot of money will enable the risk manager to incentivise the various departments within the group by awarding annual prizes for good risk management practices or results. There is a direct correlation between investment in risk management and a captive's profits. It's the circle of a risk manager's life.

Establishing a captive insurance company can be a complex exercise, but with the right consultant guiding you through the process it should be well worth the effort. Contact your broker to discuss some of the benefits above. If you are concerned that the broker may have a conflict of interest due to the possibility of lower commission if a captive is formed, then seek guidance from an independent captive alternative risk management specialist.

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