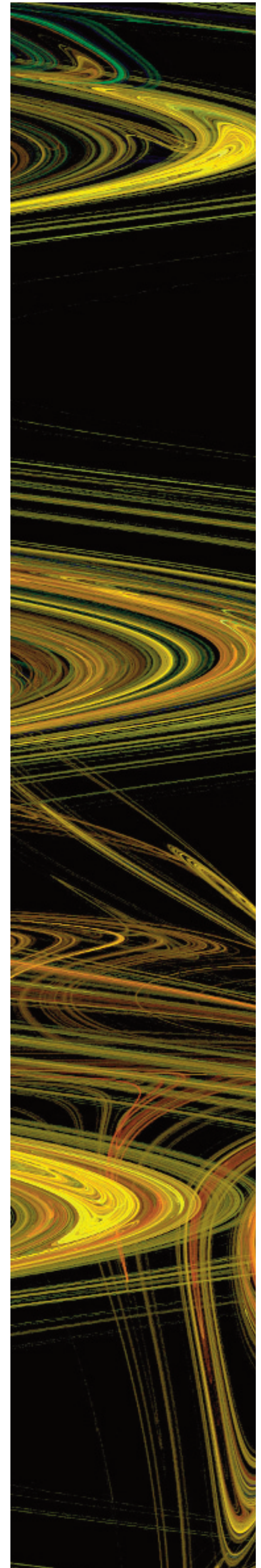
CAPTIVES

MITIGATING THE RISKS OF PRIMARY INSURER FAILURE

The insurance industry has so far been relatively unscathed by the turmoil in the banking industry. Apart from a few high profile scares, insurance buyers could be lolled into a false sense of security, thinking it is business as usual, albeit with hardening rates on some distressed covers.



However, the counter party risk intrinsic in risk transfer is just as much an issue for insurance buyers as for financial institutions lending funds. Even the most apparently secure insurer can get into difficulties (as AIG showed). The cost of such a failure would be significant for its corporate clients, leaving them with gaps in cover, a loss of servicing and certification and, most obviously, unpaid claims. The irony of well capitalized companies dependent on the weaker balance sheets of the insurance market has not gone unnoticed.

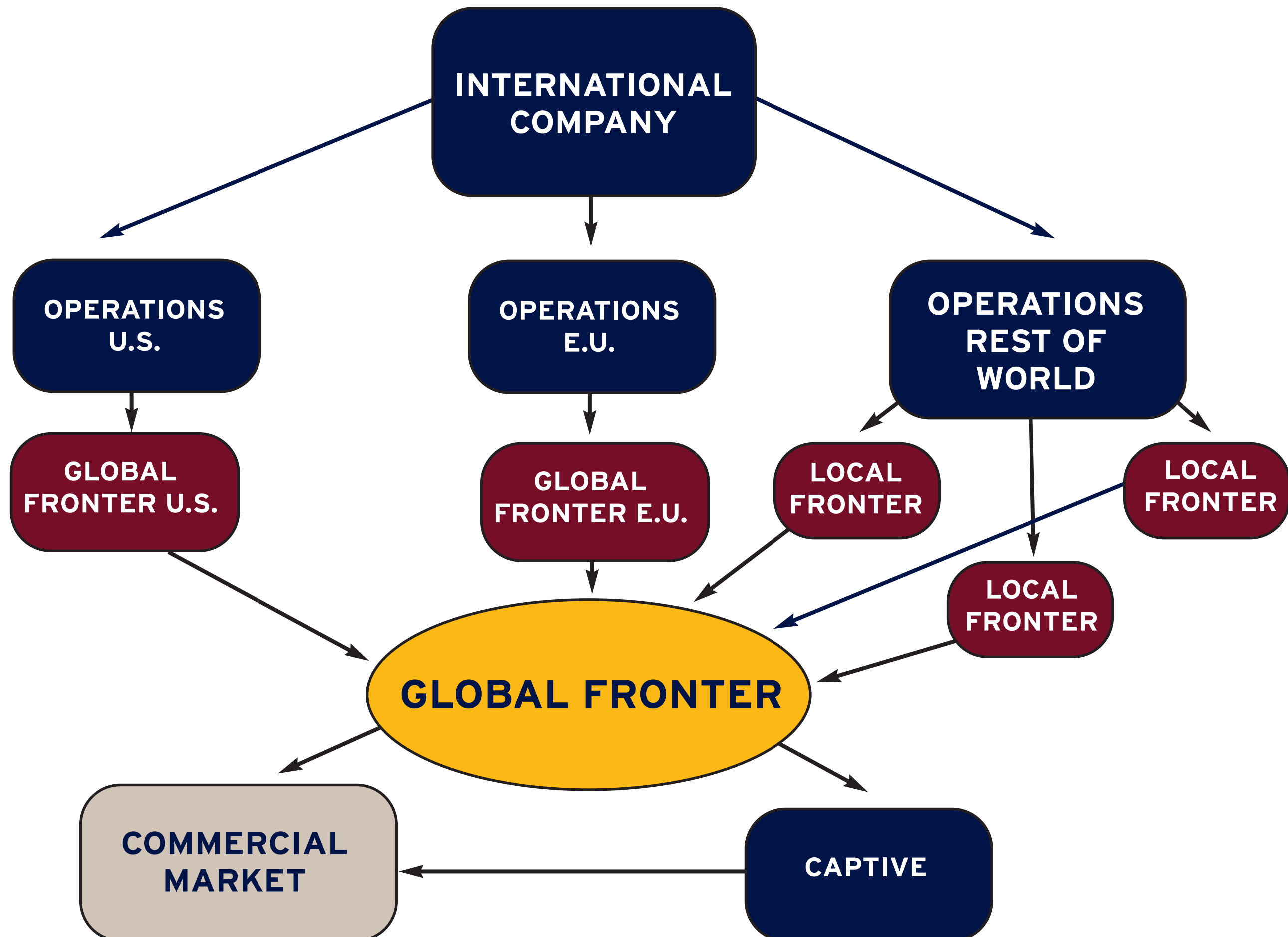
Now, therefore, may be an opportune time to look at other means of coordinating and servicing a primary insurance program that avoid concentration of risk in a single supplier. Captive owners have a valuable tool at their disposal to do just that.

Proper captive insurance program design and robust management, however, will be required to reap the maximum benefits. Overreliance on a single source of capital is not restricted to cases where a company is covered largely by a single carrier; it can happen with a fronted captive program as well. Even where the risk cannot be entirely eliminated, operational best practices can help manage financial and operational risks and protect cash flow. By positioning a captive strategically within the program and managing it properly, its owner can significantly mitigate a concentration of counter party risk. This may be especially the case with international programs.

SINGLE PRIMARY CARRIER MODELS

Most international corporate programs rely on a single carrier to provide direct insurance to operating units wherever they operate (see Diagram 1). Justification for this model is based on operational convenience, consistency of cover and the service offering of the carriers involved. However, these benefits should be weighed against their inherent concentration of risk. The failure of that one carrier would trigger a loss of cover and servicing throughout the company, with potentially damaging financial and operational effects on its businesses.

DIAGRAM 1: CONVENTIONAL GLOBAL FRONTING



Some contend that such a failure would be dealt with quickly – brokers would simply replace the failed carrier with another one. However, this assumption overlooks some very real implications.

- **Scale** Failure of a major carrier would cause the simultaneous failure of every program written by that carrier. Not only would the market be flooded with all of the carrier's now unprotected clients at once, but marketplace capacity would be significantly reduced. Even if carriers were found to replace the failed carrier in all cases, the logistics would be daunting for all concerned.
- **International replication issues** Fronting is not a generic service. Global fronting arrangements are often complex and involve more than one party in order to access all countries. Not all global fronting insurers have the same geographical footprint and they do not use the same local carriers and service suppliers where they have no presence themselves.
- **Terms and conditions** There is no reason to expect that prices and coverage would remain the same for distressed buyers in a reduced market.
- **Creditor risk** The money lost to the failed carrier cannot be recovered from any replacement insurer.
- **Security** As the failed insurer would not release existing security (i.e., LOCs, funded trusts), **there would be some degree of doubling up** as the replacement fronter would certainly require its own security.

THE ROLE OF CAPTIVES

Captives have a number of roles to play in spreading and avoiding international program delivery risks.

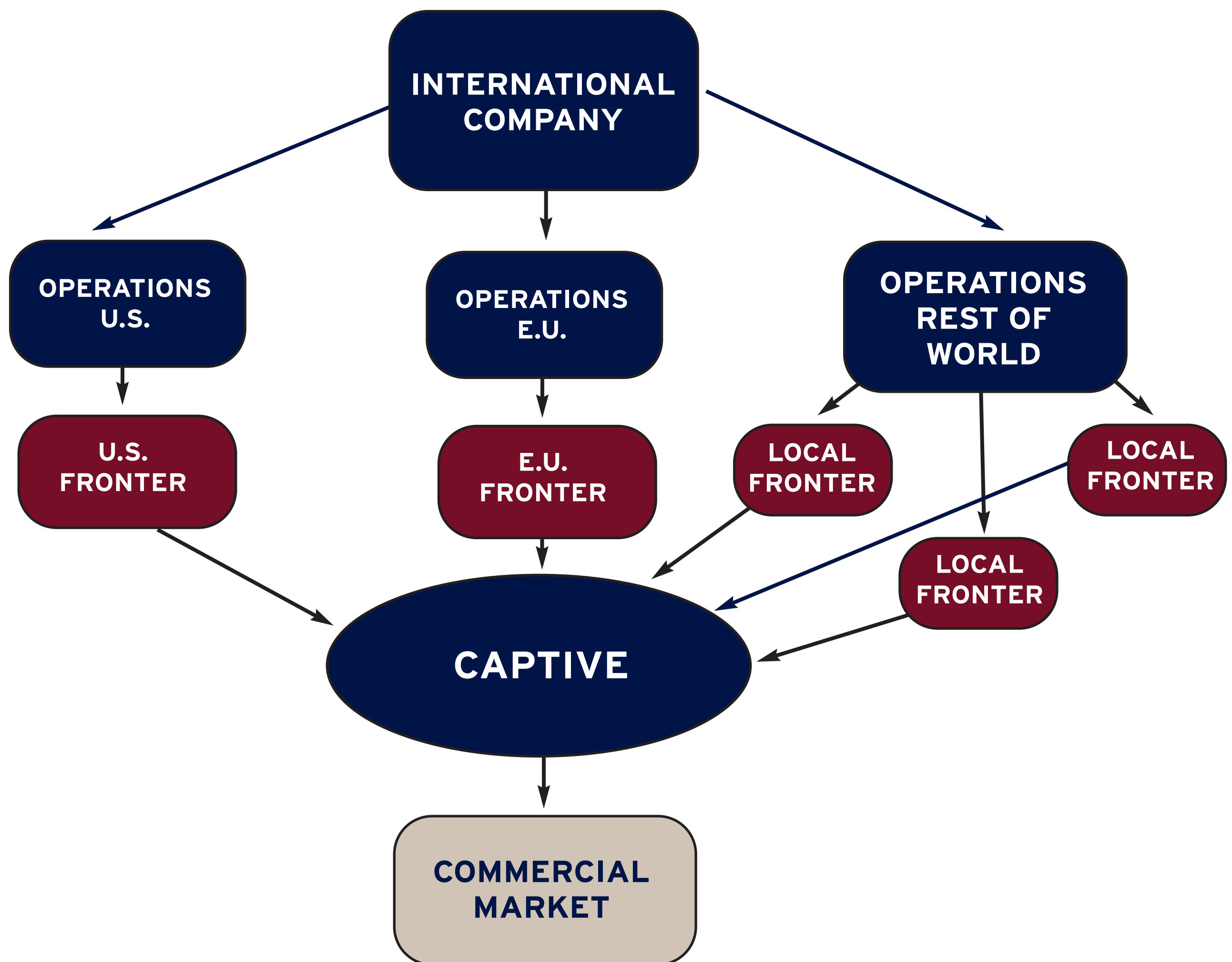
CAPTIVE AS FRONTER

A captive can write on a direct basis in many territories, acting as an admitted insurer. In the E.U., a captive based in any E.U. state can write on an admitted basis across all 30 European Economic Area (EEA) states. In the U.S., some states recognize paper issued by a captive licensed in another state.

International risks such as cargo are not subject to local regulatory restrictions on admittance and can therefore be written directly by captives. The captive can also, subject to certain requirements, issue a global Excess program above any local statutory limits.

Captive fronting eliminates most of the key financial risks inherent in fronting (including cash flow and access to ultimate commercial capacity), so it makes sense for the captive to participate as actively as possible in the insurance program on a direct basis.

DIAGRAM 2: CAPTIVE-BASED GLOBAL FRONTING



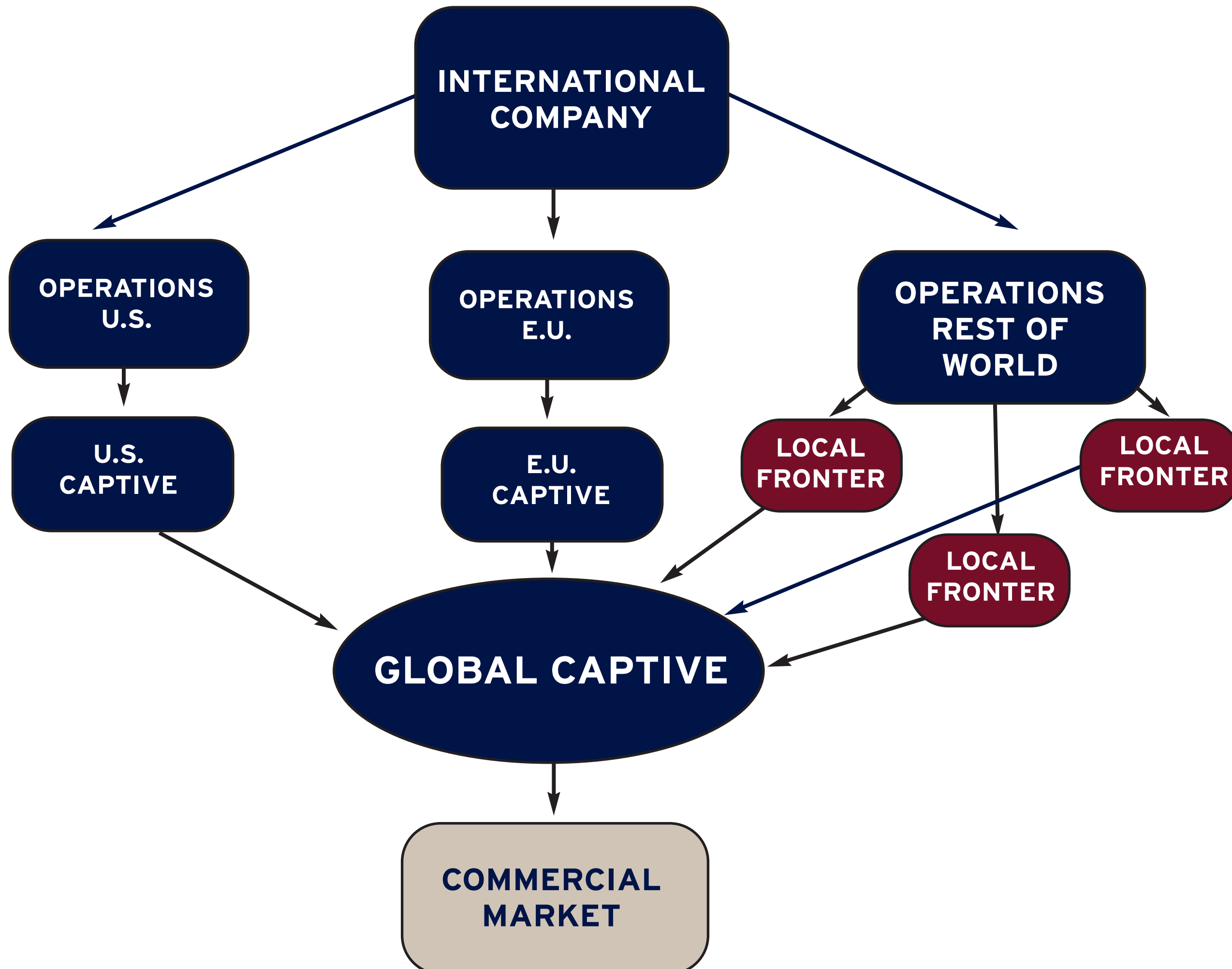
The captive in an international program can fulfill a number of functions.

- Fronting where possible
- Consolidating cover to ensure consistency of terms and conditions
- Facilitating a global placement into the international market
- Operational coordination to ensure consistent servicing standards and protocols

Restructuring a program around a fronting captive will produce a radically changed delivery structure (see Diagram 2), delivering lower risk and greater program control. The costs involved are, in the context of the risks avoided and mitigated, modest.

Fronter reliance can be further reduced using multicaptive strategies that combine the market access of a global fronting carrier with the regulatory flexibility and capital efficiency of off-shore domiciles. Diagram 3 illustrates this.

DIAGRAM 3: MULTICAPTIVE FRONTING STRUCTURE



CAPTIVE AS PROGRAM COORDINATOR

Unbundling insurance service elements can cut costs and improve service, and captives can be instrumental in making this work. Unbundling the various servicing elements of an insurance program can be achieved by appointing third-party providers (e.g., claim handlers) and by using more than one fronter (including a captive). The latter has the advantage of providing ready replacements with knowledge of the risk and acceptance of terms and conditions. It may even be possible to write into the agreements with fronting entities a requirement to replace each other in the event of the failure of any of them.

CAPTIVE AS CASH HOLDER

Increasing the role of the captive as the primary risk taker keeps cash within the group and removes the carrier counterparty risk. Access to cash significantly improves the negotiating position of insured parties in the event of an insurance failure and provides funds to overcome the negative effects of the nonpayment of claims during the often lengthy administration of the failed carrier.

Cash flow risks can also be substantially reduced by sensible housekeeping and careful credit control.

RISKS ASSOCIATED WITH FRONTED CAPTIVE PROGRAMS

There are a number of risks arising from the relationships between fronting carriers and captives.

SECURITY ISSUES

An insurer acting as the front to a captive will typically seek significant security from the captive in respect of its obligations under the reinsurance agreement. Usually the demand is for a letter of credit which is irrevocable and unconditional, thereby placing captive assets at the behest of the fronting insurer.

In the event of the insurer going into administration, liquidation or receivership, the funds may, appropriately or not, be drawn down. In the absence of effective documentation of arrangements, the recovery of funds so drawn can be subject to discount. It is important therefore to ensure that documentation is robust and allows drawings against the LOC only in settlement of legitimate claims.

The value of letters of credit should be renegotiated at each renewal and recognition given for any losses paid in the period, reductions in reserves and changes in unearned premium calculations driven by policy period changes. Replacing letters of credit with security trust arrangements gives greater protection, as the trustees have a responsibility to ensure any funds drawn down are in settlement of legitimate claims under the policy.

Many fronting insurers also require captives to establish escrow accounts to fund claim settlements. When possible, these should be resisted. If required, they should also be established under a trust agreement with the bank account in the captive's name and the captive retaining control of the account.

DOUBLE INDEMNITY

Should a fronting insurer become insolvent, there is an issue of double indemnity in that the claims on the direct policy will not be paid and the captive will still be required to respond to any loss under the terms of their reinsurance agreement with the fronting carrier. The use of pay-as-paid clauses has been promoted as a means of avoiding this risk, but legal advice should be sought as to the effectiveness of such wordings, as they are not universally effective. Other potential solutions include contingent cut-through clauses or even cancellation clauses. However, care should be taken to ensure that any protection used is effective and enforceable in prevailing circumstances.

CASH FLOW

Local insurance regulations make it impossible to completely avoid the need to pass premiums and claim payments via the fronting carrier. It is therefore important to implement appropriate

controls and protocols. All payments should be coordinated (and where possible simultaneous settlement should be arranged) to minimize the time funds are held by the fronting insurer and their broker. Same-day settlement methods should be used rather than checks.

Service standards for transfers by the fronting carrier should be documented in policy wording or in a terms-of-business agreement. The currency of the transfers should be denominated and, where currency translations cannot be avoided, a predetermined exchange rate should be agreed to avoid foreign exchange risk. All bank account details should be documented in advance to avoid any confusion that may delay settlement. Compliance by the fronter should be monitored by the captive manager.

Delayed premium payment terms should not be extended by the captive to the fronter and substantial premiums should be payable in installments rather than in one lump sum. The captive should only reimburse the fronter once claims have been settled with the insured; the captive should not be funding such claim payments. The right of offset should also be included in the reinsurance wording.

SEIZING AN OPPORTUNITY

Insurance buyers should be looking to their brokers and captive managers for advice on optimum insurance program design, captive participation and the management of counterparty risk. The captive manager has a potentially central role to play as facilitator and communicator to all stakeholders. While a captive's corporate governance platform may recognize some of the issues outlined above in a general sense, the current economic situation merits a full and close review of these risks and the mitigating tactics that can be adopted. We recommend this remains a standing agenda item for captive board meetings and group risk management committees until the current economic crisis has subsided and, indeed, beyond.

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