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SOME THOUGHTS ON INSURANCE PROGRAMMES AND OTHER RISK FINANCING METHODS

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Risk management has gained momentum over the past 10 years. It is understood today as a wide-ranging and on-going process, geared to the totality of entrepreneurial activities. Instead of reacting to unwanted exposures and incidents there is now action. Action that reflects a conscientious and systematic analysis of the risks that businesses create through their activities. Businesses now communicate, discuss problems in advance instead of waiting until they are compelled to act. By measures such as quality assurance processes, total quality management, process safety, workshop safety, neighbourhood and community information programmes, etc. the general communication and safety level in responsible enterprises has been and is being increased both internally within the enterprise and externally towards individuals, institutions, organizations and the community. Annexe 1 shows how the enterprise is involved in a social network and how it has to cope with different dimensions.

Annexe 1 : NETWORK

The measures I mentioned allow the enterprise to create a "safety and quality culture", which is not only a basic prerequisite for the general business, but also of fundamental importance for a sucessful insurance programme and for alternative risk financing tools, such as captives and Captive accounts.

With the above we have established the general basis. Let me now focus on the following subjects:

First:	How to organize an international / global insurance programme - some main issues.
Second:	Alternative risk financing tools.

Under the first subject I should like to talk about

- the need for risk information
- the choice of the "right" insurer
- decentralization vs. centralization
- the need for an insurance policy

Risk information: Before developing an insurance programme risk information should be available, covering the following items:

- risks insured / not insured, locally
- premium / loss history of the past five years (at least)
- sums insured, extent of coverage under local insurance policies, amounts self-assumed (deductibles)
- estimates of the loss expectancy, particularly in respect of fire insurances (maximum forseeable loss, estimated maximum loss, etc.)
- special local exposures

These data serve as a basis for the portfolio analysis and for the negotiations with the insurers. Furthermore they set also the basis for the cost / benefit calculations if it comes to establishing an alternative risk financing tool.
After introduction of a concept the risk information should be currently updated by means of a groupwide risk information system. This fosters active participation from local managements and makes them aware of the cost of risk and of the kind of risk they create through their activities.

The "right" insurer: Choosing the "right" insurer depend on two main criteria:

- <u>security:</u> Here I should like to stress that first class security is not always the cheapest. But first class security will be there when one needs it most: in case of a catastrophic event.

-3-

° serviceability: The insurer of your choice must be allowed to do business in those countries where your Concern maintains production or sales units. Thus local managements have direct access to the insurer.
The serviceability of the insurers, including their competitive edge, should be re-appraised periodically (3 to 5 years).

Centralization / Decentralization?

This is an "evergreen" question. A Concern that gives - in the framework of the budget objectives - autonomy and self-responsibility to its Group Companies will usually decentralize also the management of the insurance programme. In fact there is much to be said in favour of this solution. Above all it involves local managements and leaves room for creativity in tailoring a programme to local needs, particularly in local operational segments. On the other hand the placement of catastrophe covers, e.g. in the liability area, should be centralized (one buying point!).
It is also conceivable that e.g. a medium-sized enterprise may tend to lead and execute an insurance programme exclusively from the centre by means of a master programme.
There is, in my view, no right or wrong solution for all circumstances in this field. The solution depends entirely on a given Concern's management philosophy and culture.
Incidentally the question can become a subject of a discussion with Group Companies when, e.g., implementing a single policy approach in Europe ("Europolicy") under the provisions afforded by the second Non-Life Directive.

Insurance policy: Irrespective of the way an insurance programme is being managed: a central corporate insurance policy endorsed by Top Management is a must. The policy paper should briefly

° describe the concept of insurance
° state the risks to be insured / not to be insured
° name the insurers a Concern does business with

° regulate responsibilities and controlling

All other subjects should be dealt with in separate guidelines. This concludes the first part of my talk.
I should now like to shed some light on alternative risk financing tools, such as the captive and the captive account as well as the financial insurance approach.

Let me start with the group-owned insurance company, the captive. What is a Captive? I do not wish to bore you with a multitude of definitions - there are definitions aplenty. But here is a brief one which illustrates what a captive is:

Annexe 2: DEFINITION

May I add a few remarks to give you a better understanding of the captive idea:

First: Methods of operation
Captives may operate as reinsurers or as primary, direct insurers. Captive owners mayalso decide that their captive should undertake both functions, depending on the legal requirements of the country the premiums stem from.Today the majority of captives are reinsurance captives. This pattern may change particularly for businesses with significant exposures in Europe in the light of the EC's second Non-Life Directive.
Second: The location
Currently most captives are located in centres, such as Bermuda, The Cayman Islands, The Isle of Man, Guernsey, Ireland, Luxemburg, to mention a few. Captives number about 3200 of which more than 60%are located in the above centres.
Third: Types of captive
Captives may be owned entirely by one parent (single-owner captive) or owned jointly with other corporations (association captives). Single-owner captives still represent a majority.

Why is a captive formed?
The main reasons for forming a captive can be broken down into the following categories:

Annexe: REASONS.....

In times of scarce capacity (capacity means the largest amount of insurance or reinsurance available from a company or from the Market) a Concern may not be able to obtain the limits required to cover its exposures to possible catastrophes, be this in the casualty or in the property class of insurance.
In such situations a captive can be useful. Through its own capacity contribution it can help to put together the capacity needed. Over time, this kind of support may help to maintain the capacity limits once obtained. In the field of cover a captive can be instrumental in setting up programmes and special risk covers tailored precisely to the needs of the captive owner.
A core issue is, of course, the cost of insurance. As I said in my introductory remarks the captive insures better than average risks resulting in a better than average loss experience. It can, therefore, write significant portions of the risks and cash the premiums connected therewith. Here lies the true saving potential of a captive: Part of the premiums paid by the companies of a global enterprise can be kept within the enterprise for current investment. The better than average loss experience enables the captive to set aside ample reserves for unknown future losses. In this way it acts as a funding mechanism.
So far I omitted any mention of the tax aspect. Indeed I play down this aspect deliberately because when measured against other reasons taxes are, in my view, not the first priority. Priority should be given to the insurance function, as we have seen. However, a captive owner may reasonably expect its captive to be tax-efficient as well. The question is: to what extent.

Let us now take a brief look at the last reason for forming a captive: its function as as efficient risk control vehicle. It is obvious that a captive is particularly well placed to perform this function. It has a central overview of the loss patterns and the losses paid / reserved and can, consequently, easily provide a constant information flow to the Parent. This function is of special importance in global organizations with a decentralized business policy. On the other hand it must be mentioned that risk control alone is no justification for forming a captive. A well organized insurance programme may be able to perform this function just as well..

How does a captive work? I said earlier that a captive may function as a direct insurer, or as reinsurer or both.

First: the reinsurance captive, how does it work? The risks / premiums can be written on a quota-share basis (i.e. the captive accepts a defined percentage of the premium/ risk), or on an excess of loss basis (i.e. the captive accepts a defined premium / risk segment in excess of a defined limit), or on a combination of both. May I illustrate the typical finance flow of a reinsurance captive:

Annexe: FINANCE FLOW

Second: The direct insurance captive It is also called a "domestic captive" because it usually operates as an admitted insurance company domiciled in the country where the Parent has its Head Offices. The direct insurance captive works like any other insurer, normally as a coinsurer. Acting as co-insurer relieves the captive from calculating the "reasonable" market premium, a not unimportant aspect from the point of view of dealings with the tax authorities. If the captive does not act as co-insurer, it would need underwriting specialists.

-7-

Like any risk financing instrument a captive has its advantages and disadvantages. The main advantages are identical to the reasons for forming a captive.
There are, however, some disadvantages that require careful consideration. To mention a few:

° the starting capital required
° The limited spread of risks
° Involvement of management time / management costs
° general technical costs
° retrocessional costs

Starting capital: The minimum capital required by local regulations may initially be adequate. Depending on the risks to be accepted - think of liability risks and other long-term risks - a captive may need a higher capital, a risk capital even, to build up its portfolio and to extend its writings later. Captives acting as risk bearer are capitalized accordingly, sometimes with a capital clearly in excess of CHF20M. This shows that a captive owner may have to invest funds that require a certain financial stature.

Limited spread of risks: Statements abound that any major direct professional insurer has an advantage over the captive in that its spread of risk is very much larger. Therefore the captive must, within its limits, strive to optimize its portfolio: it must establish the necessary mix and strike a balance between short-term and long-term risks (if both risk categories are accepted). Furthermore it must aim to establish a broad geographical spread.

Management time / management costs: The captive requires proper management at its domicile and also demands management time of the captive owner. Particularly the latter cost element is often overlooked.
In many cases the day-to-day business is run by independent management companies. However, with the growth of a captive and the means accumulated over the years captive owners

-8-

increasingly have their captive managed by their own people.

General technical costs: These costs can be quite significant, particularly if the captive acts as a reinsurer. In such cases a service fee has to be paid to the ceding primary insurer (handling of reinsurance accounts, payments, etc.) which must be re-assessed periodically).

Retrocessional costs: Depending on the risk written and their loss potential reinsurance of the captive may be necessary to portect it against catastrophic events.

These cost aspects show you the importance of careful planning before setting up a captive. This is usually done by means of a feasibility study. Here are some of the main elements to be considered:

ANNEXE: CHECKPOINTS

I should now like to return to the location issue. Which domicile should be chosen for the captive? What are the main criteria to be considered? They are:

- consistent government policy of support for financial services, such as captives
- Reasonable supervisory control of inssurance companies, including captives
- availability of financial, legal and other professional services
- no exchange controls
- working infrastructure
- tax efficiency

Are there other risk financing tools?

The result of the "Feasibility Study" may persuade you to decide to drop the captive project: What alternatives would you have then?

The captive account: A smaller enterprise may find value in a captive, but lack the financial resources to form a wholly-owned insurance subsidiary. In such a case a captive account (rent-a-captive) placed with an insurance company of your choice may be a suitable alternative. This insurer will administer the policies and the pooling of the premiums. Normally this insurer is also the leading carrier, quotes the premiums, underwrites the risk and takes also care of the reinsurance. The participation of the captive account client follows the same technique as applied under a captive system.

The main advantage of this solution is obvious: you will not have to spend money for foundation costs, share capital and possibly for additional risk capital.....

On the other hand the captive account insurer will require a fee and commissions. Both cost components are, however, negotiable.

Conclusion? If a Concern wishes to participate in its risks the captive account is, in my view, a solution that should be looked into before founding a captive.

Financial insurance: The objective of this cover is

° to protect the balance sheet againstthe financial impact
° resulting from a catastrophic event
° for which there is no insurance cover.

From a systemic point of view financial insurance is a combination of classic insurance thinking and financial mathematics. The insurance component is the underwriting risk. The financial component is represented by the time risk in that the insurer has to calculate the expected

° yields from the premiums paid,
° loss-pattern, i.e. the expected distribution of the losses over the contract period.

-10-

The premium for this funding method is rather high (e.g. a guaranteed limit of CHF10M for a, say, 3year contract period may cost about CHF2.5M* depending on the risk involved).
Financial insurance may have a certain attraction also for the industrial buyer particularly when it comes to funding non-insurable risks.

* per year

In conclusion let me SUM UP:

1
A risk information system is the backbone of an insurance programme. This is even more so when you support your insurance programme with a captive insurance company or a captive account.

2
When choosing the "right" insurer do not look for the one offering the cheapest premiums.Security and serviceability should be the watchwords.

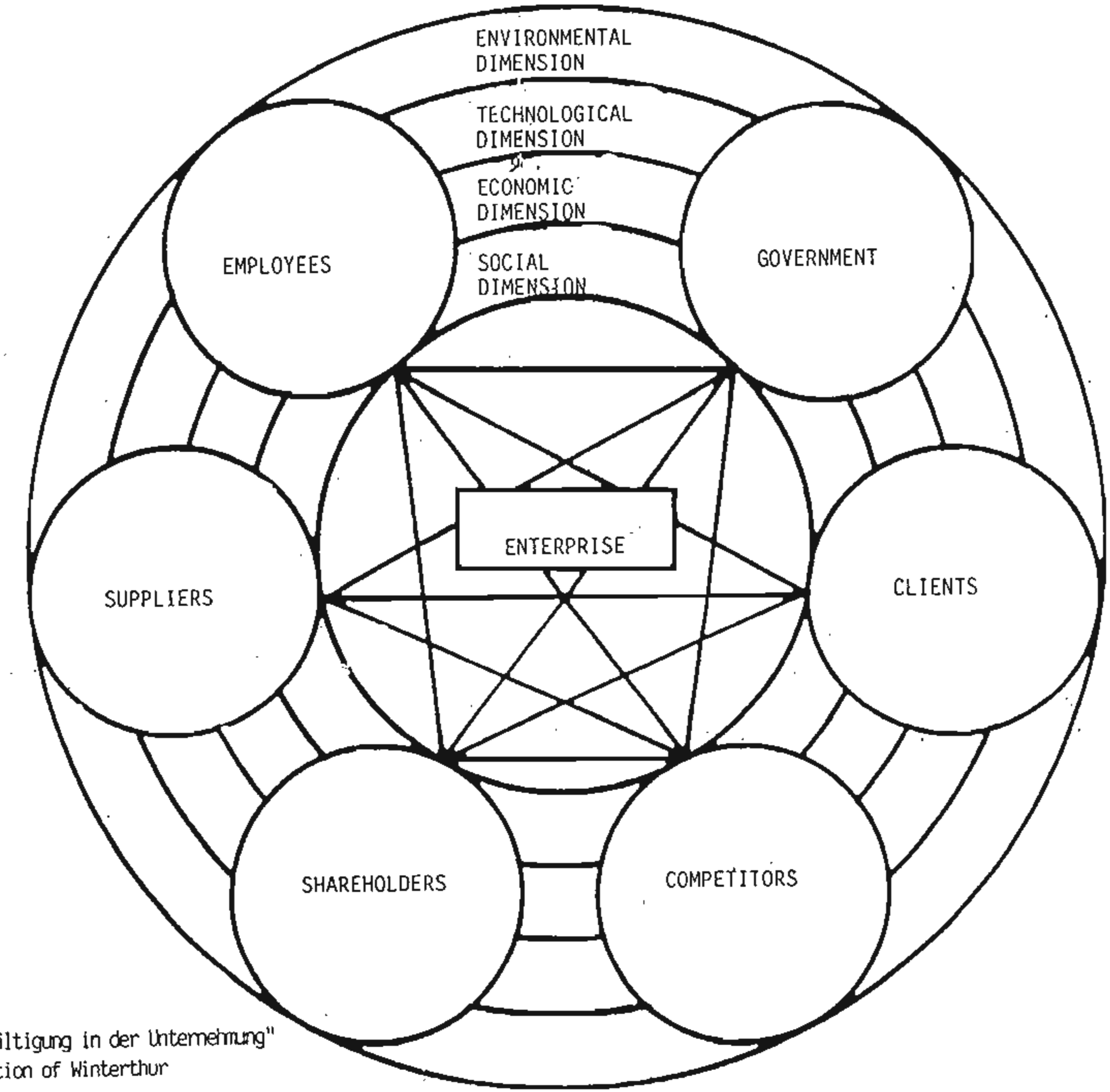
3
Whether or not one centralizes or decentralizes the management of an insurance programme depends on the management philosophy and culture of a given Concern. But: at the end of the day the "red pencil" may be the decisive element!

4
An insurance policy endorsed by Top Management is a must.

5
A captive company can be a very beneficial tool. As a capacity provider. As a saving instrument. But a captive should not be regarded upon as a "profit centre". The main disadvantage are the capital cost to put a captive on stream.

6
The captive account placed with an insurer of your choice is a valid alternative. Before planning a captive this option should always be appraised.

7
For the industrial buyer financial insurance may have a certain attraction when it comes to funding non-insurable risks, in an effort to protect the balance sheet.



Source:
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WHAT IS A CAPTIVE?

IN SHORT.......

.... A CAPTIVE IS AN INSURANCE COMPANY

OWNED OR CONTROLLED BY AN ENTERPRISE /

CONCERN AND OPERATED FOR ITS NEEDS

RATHER THAN FOR AN OPEN MARKET.............

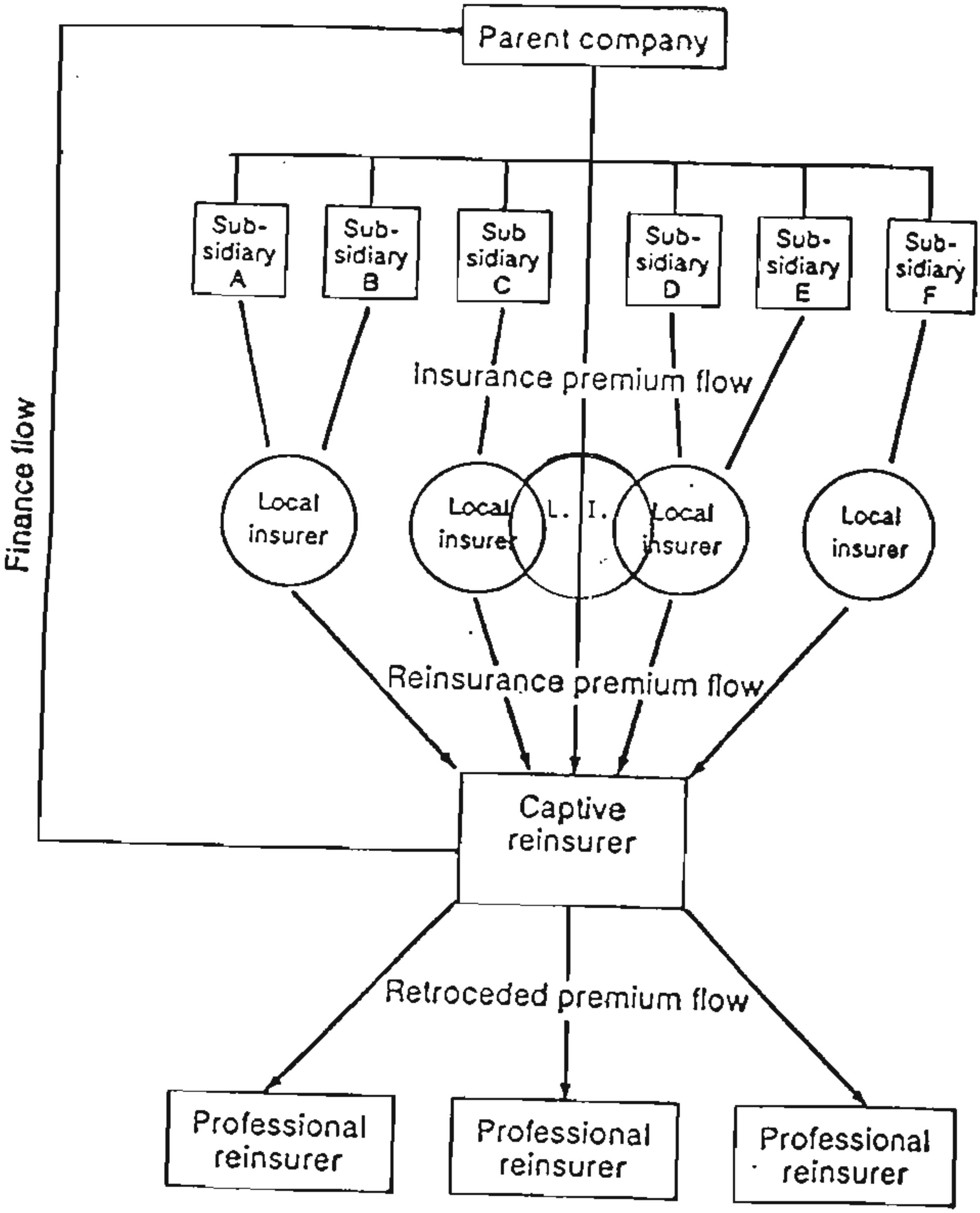
THE REASONS FOR FORMING A CAPTIVE

.MEETING INSURANCE NEEDS
CAPACITY, COVER

.OPTIMIZING THE COSTS OF RISK-FINANCING

.PROVIDING A FUNDING MECHANISM

.ESTABLISHING AND MAINTAINING AN EFFICIENT
RISK CONTROL VEHICLE


Parent company
Sub-sidiary A
Sub-sidiary B
Sub sidiary C
Sub-sidiary D
Sub-sidiary E
Sub-sidiary F
Insurance premium flow
Finance flow
Local insurer
Local insurer
L. I.
Local insurer
Local insurer
Reinsurance premium flow
Captive reinsurer
Retroceded premium flow
Professional reinsurer
Professional reinsurer
Professional reinsurer

FEASIBILITY STUDY: CHECK POINTS

ANALYSIS

- Risk information, containing:

- Premium / loss history (last 5 years)
- Extent of cover of primary insurance contracts
- Sums insured
- Local deductibles
- Loss estimates

Objective: To evaluate whether or not a captive would have been a successful solution in the past

TECHNICAL ASPECTS

- Which insurers are interested in a captive concept?

- Should the captive function as primary insurer (if so: on a coinsurance basis or as a direct insurer) or as reinsurer?

- Which risks should be transferred to the captive? From which countries (insurance legislation)?

- If the captive operates as reinsurer: check the transfer conditions of the ceding primary insurer

- On which basis should the captive participate in risks and premiums: on a quota-share basis? on an excess of loss basis?

- How big is the underwriting capacity by class of insurance?

- How big is the retention?

- How big is the minimum capital required by law? How big is the additional need for capital?

- Cost / benefit projection (premium expectancy, loss expectancy, reserves needed, expected investment income)

- Where should the captive be located? "Off-shore"? Country of domicile of the Headquarters? What are the business requirements? What are the legal implications (insurance laws, tax efficiency)?

- Organizational issues (accounting, auditing, etc.), responsibilities captive owner / captive (regarding underwriting, investment, general business policy, etc.).