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ALTERNATIVE RISK FINANCING MARKETS

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Alternative Markets

U.S.Update and a Brief Case Study — Edith F. Lichota

I. U.S.Update

A. Liability Risk Retention Act of 1986 authorized the creation of Risk Retention Groups (as had an earlier version of the Act) and also of Purchasing Groups, which were a new feature of the legislation. The act came on the scene when the worst of the last hard market was softening somewhat, but there were still specific kinds of exposures, particularly in the liability area, that were hard to insure. As a result, inspite of the softening market, the use of alternatives, including those made available by the 1986 Act, has continued to grow.

1. As of February 15, 1989, the Risk Retention Reporter had counted 337 Purchasing Groups, of which a significant majority was serving the medical/dental community. The next largest contingent was in the professional service area, and environmental concerns were the basis of participation by the third group. Purchasing Groups are independent corporations which joint together for the sole purpose of pooling their insurance buying in order to control sufficient premium to try to make them selves acceptable to commercial insurers who are unwilling to underwrite them individually. At the present time, state court decisions make the policies the group members buy subject to rate and form regulation in every state where there are members. RIMS believes that this is inconsistent with the spirit and intent of the law and is trying to get it changed.

2. Risk Retention Groups are formed for the purpose of underwriting the liability risks of their homogeneous membership. Some off shore captives were brought onshore by their U.S. owners after the 1986 Risk Retention and Tax Acts were passed, but there has been, by no means, the kind of major relocation into the U.S. that some observers had expected. Some of the reasons for this are the reluctance to entrust themselves to the U.S. court system, and a somewhat general belief that U.S. taxing practices are too unpredictable to rely on. Risk Retention Groups are a type of captive, and they are thriving along with the rest of the participants in the alternative market scene.

3. Captives, more generally, did not wither away as a result of the 1986 Rax Act. For those of you who may be unfamiliar with this legislation, it made life much more difficult for insurance companies generally and off shore captives in par-

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ticular. One of the provisions most adversely affecting all insurance companies (including captives) is the requirement that reserves be discounted and unearned premium reserves be reduced by 20%. It has been estimated that a successful company could have its reserves taxed away in about 7 years if this provision is not changed. For off-shore captives insuring U.S. risks of U.S.shareholders, the law requires that the profit be calculated as if the captive were a U.S. company and the profits must then be declared by the U.S. shareholder for taxation purposes. The off shore company has the option of choosing to be taxed as a U.S. entity, but this is an irrevocable election and also carries a high price. Inspite of what were called the anti-captive provisions of the Unite States law, the captive and alternative markets are thriving in the U.S. Even single parent captives continue to be used for specialized purposes, and a recent court case has given them a real boost; in it, the court ruled that the United States taxing authorities were incorrect when they denied the tax deductibility of all premiums paid into a captive company with a common parent -- what is called a common economic family. The court said that it was spread of risk that was the determining factor and that sister corporations, paying premiums to another subsidiary of their common parent, were, indeed, spreading risk, buying insurances and paying in tax deductible premiums. Whether that decision will prevail remains to be seen; the rulings of one circuit in the United States are not binding on all others.

4. As the cradle of much of this captive activity, it is interesting to see how many of the states are now trying to duplicate the success of Vermont in making itself attractive for captive creation. This activity is probably one of the most convincing indications that the captive growth is with us to stay. Another indicator of this fact is the position recently taken at a meeting of the National Association of Casualty & Surety Executives and the National Association of Casualty & Surety Agent. Brokers were warned by their own officers not to regard alternative markets as adversaries but as one of the viable options they have a duty to explore for their clients. Of course, buyer dissatisfaction with traditional markets has been well documented, and it shows no signs of early reversal.

II. A brief case study -- the story of BICL.

A. Bankers Insurance Company, Limited was created by commercial banks in the U.S. to provide Directors & Officers Liability insurance and additional bond capacity.

B. It was a direct outgrowth of the last hard market and the dramatic shrinkage that occurred in the market for these covers for financial institutions. The feasability study was commenced in mid 1985 and the first policies were issued in Bermuda in May of 1986.

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1. Federal Reserve approval; a first.
2. Reinsurance issues.

C. Corporate Objectives:

1. Predictability and stability.
2. Breadth of cover.
3. Support of the commercial market.
4. Recognition of experience; loss sensitive rating.

D. Current Status

E. Why it is typical.

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