Artex | Alternative Risk

Five Different Types of P&C Risk Finance Solutions: Pros and Cons

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Companies of all shapes and sizes have one thing in common when it comes to purchasing property and casualty (P&C) insurance — it's a daunting task at all levels. Ultimately making the business decision as to which insurance solution best suits the needs of any company has a direct impact on its business going forward. As your company grows in size, the options for different types of insurance solutions grow as well. Early on, the company might have been a size where you could only look for insurance that is full risk transfer, which is first-dollar coverage or guaranteed cost in nature. As your company grows, it opens up the opportunity for more risk-taking options. Wherever your company stands with its desire and ability to take risk will have a direct effect on which of these solution choices makes the most sense. Similarly, the conditions of the insurance marketplace in regard to rates and ability to obtain coverage will also impact which solution will provide the best overall solution.

THIS WHITEPAPER EXAMINES THE PROS AND CONS OF:

1. Five different types of P&C insurance solutions that are available to midsize and large companies, including guaranteed cost, rent-a-captive, group captive, single-parent captive and large deductible programs.
2. For each of these solutions, we will delve into the benefits, the insurance market cycle and the risk-taking positions that fit them best.

Before we dive into the insurance solutions, let's offer some background on the two parameters we are using to gauge each solution: a company's risk appetite and the insurance market conditions.

First is risk appetite, which typically is qualified as risk averse or risk taking. Risk averse in this context typically means a company is not willing to take their own monetary risks for their insurance and would like to transfer all that risk to another entity at a cost, whereas risk taking is where a company is willing to take monetary risks to some degree in an effort to limit costs that are associated with the transfer to another entity.

The following are areas to consider when determining your risk appetite:

- ☑ Financial ability to retain risk and pay claims
- ☑ Frequency and severity of claims
- ☑ Risk management practices
- ☑ Ability to post collateral
- ☑ Cash needs

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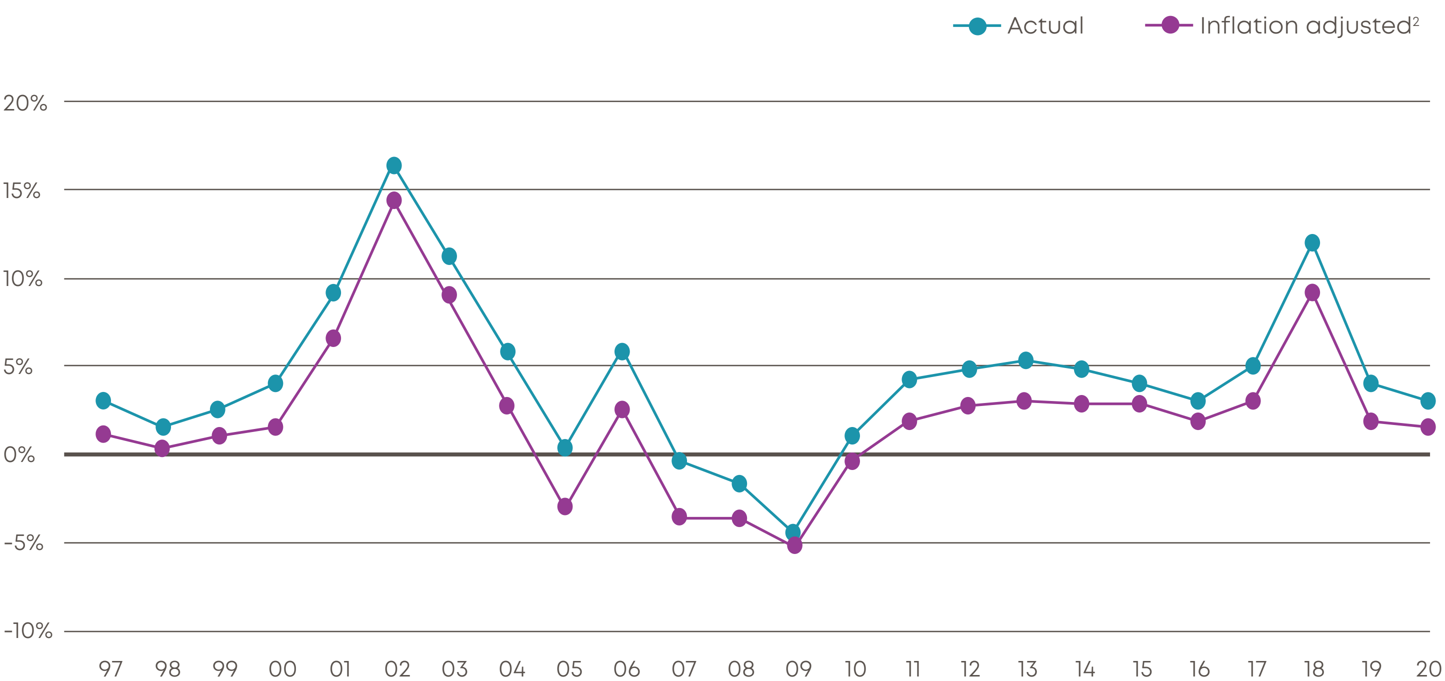
Second is the insurance market cycle. The P&C insurance market cycle is characterized by periods of soft and hard market conditions. During soft market conditions, premium rates are stable or falling and insurance is readily available. Soft market conditions are typically followed by periods of hard market conditions, where rates rise, coverages may be more difficult to find and insurers' profits increase. The main factor in this cycle is typically determined by competition within the industry. Premiums typically drop when insurance companies are seriously competing to grab market share. This heavy competition will ultimately soften to a point of diminishing profits, where insurance carriers start to exit the market and standards become more intense. At this inflection point, premiums start to rise again and certain coverages become less available, thus creating a hard market. The following graph shows the changes from hard to soft market over a 23-year time span to give you the history of the insurance market cycle.

Percent Change From Prior Year, Net Premiums Written, P/C Insurance, 1997–2020[1]



[1]Insurance Information Institute: https://www.iii.org/publications/commercial-insurance/how-it-functions/market-conditions-cycles-and-costs
[2]Adjusted for inflation by the Insurance Information Institute using the GDP implicit price deflator.

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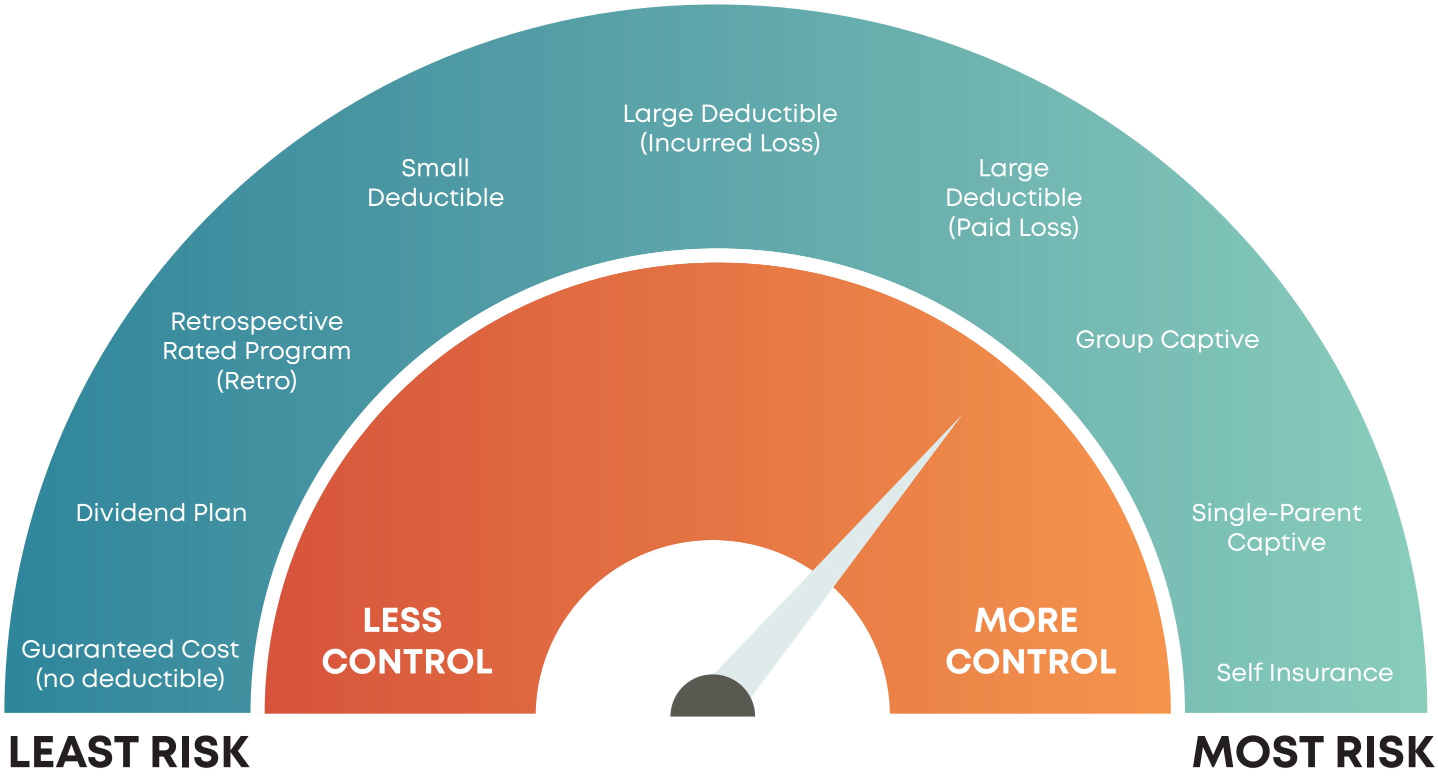
INSURANCE SOLUTIONS

Let's begin to explore the various insurance solutions available, with an understanding that willingness or desire to pursue different risk financing vehicles will affect the decision you make. Risk can be managed or financed through a number of different vehicles, ranging from guaranteed cost to pure self-insurance. With each option comes a varying amount of risk assumption, financial need and control.



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1. GUARANTEED COST PROGRAMS

These programs are best suited for:

- Companies that are completely risk averse and look to transfer all their risk to a third party for a premium
- Smaller companies that cannot financially take risk
- A soft market — when competition for insurance carriers are high, the premium prices will drop and additional coverages will be more available

A good risk-performing company can get both the benefit of being a desired account in a competitive market as well as the benefits from their good experience via experience modifiers or safety credits to provide further discounts to their reduced pricing. However, these programs can have the opposite effect in a hard market. Insurance carriers will look to garner some type of rate return to offset diminishing profits, and even the best of risks can get caught in the increase in price cycles.

Different solutions lines can be going through different market cycles. For example, right now Workers' Compensation is in a soft market. Carriers have had success over the past 10 years, and states that control the rates for this coverage have been continuously decreasing them over that time. At the same time, a casualty coverage, cyber liability, is in an extremely hard market cycle. As losses have been occurring and insurance carriers are not sure how to price the risk, companies are seeing double-digit and even triple-digit price increases for this coverage. Therefore, the market cycle plays a large role in this type of program, but they are the best fit for those whose companies do not want to take risk. When price cycles change, the first line of defense for a company is typically taking on a deductible. Agreeing to take a defined amount of risk on a per-claim basis has direct impacts on premium. Deductible amounts can range widely from assuming a small dollar value per claim to a significant amount for each loss. The threshold of the deductible will have a direct impact on the premium savings. This is often viewed as the beginning point for taking risk.

What is a captive?

A captive is a special-purpose legal entity that is licensed as an insurer and established primarily to insure a proportion of the risks of its sponsor — often a corporate parent, group or association.

2. RENT-A-CAPTIVE PROGRAMS

These programs tend to be attractive:

- For companies that are comfortable taking risk but want the certainty of defining how much risk
- For companies that want to share some risk with a group
- For companies that want to take advantage of group purchasing power to reduce premium costs
- Because no ownership requirements means easier entry and exit from the program, versus a traditional captive
- Because these programs have advantages in both soft market and hard market cycles — from a long-term approach, these programs offset market cycles with profit returns and reduction in overall insurance costs

Rent-a-captive programs provide clients an already established captive model where the company takes risk with a group of other companies without any ownership in the captive. They can provide companies the ability to receive profits based on their individual performance, as well as those of the other companies in the structure. As these programs provide no ownership to the captive, companies do not need to provide an upfront buy-in and typically have the ability to leave without penalty. Insurance market cycles can play a role in these

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programs, as additional costs of collateral and waiting on established profits of the captive can be expensive in comparison to a guaranteed cost program in a soft market. However, as the market hardens, these can in turn become benefits to offset the pricing increase of a hard market. Rent-a-captives are a program type that allows companies to test a risk-taking environment without too much commitment to a long-term approach.

3. GROUP CAPTIVE PROGRAMS

These programs are best suited for:

- Companies who are comfortable taking risk with a commitment to safety and good loss experience
- Companies interested in sharing some risk with others in a group setting
- Companies looking for benefits that include group purchasing power to reduce premium costs in both soft and hard market cycles — the use of group captives creates a long-term approach that offsets market cycles with profit returns and reduction in overall insurance costs

Group captive programs allow midsize companies to take risk and receive benefits in a similar fashion to large companies that can more easily form their own single-parent captives and disperse their own risk taking. Group captives are established by like-minded companies that want to come together and share in owning their own insurance program. Typically these programs are set up as a mutual or stock company and are formed in one of many established domiciles. The selection of an onshore or offshore domicile is based on a number of factors, primarily on regulations that align well with company goals. In addition to domicile selection, owners of the group captive also manage service provider selection, structure and amount of risk assumed, as well as who else can join the group captive and become an owner. The group captive owners benefit from favorable loss experience by the recouping of underwriting profits versus those profits going to an insurance carrier. Additionally, investment income dollars earned on premiums are retained by the owners, which, if structured well, can be key in net insurance cost. For those who are concerned about significant exposure, a group captive will typically still have protection in the event of large or excessive claim activity via the group captive's reinsurance structure. This does result in some impact on pricing due to market conditions, but the impact is greatly reduced, as the amount of insurance being purchased is greatly reduced.

4. LARGE DEDUCTIBLE PROGRAMS

These programs tend to be attractive to the following:

- Companies looking for an upfront cash flow improvement since losses are paid as claims are paid
- Large companies with multistate exposures
- Companies with the financial capacity to self-insure part of their liability risks and provide collateral for credit risk
- Companies looking for benefits that include removing the market cycle shifts; strong internal risk management professionals that have the ability to manage claims and control the risks of the company—the ability to take advantage of the immediate cash flow benefit and build a profit center by controlling losses over the long term are additional benefits

Large deductible programs are risk-taking vehicles wrapped within a guaranteed cost scenario for individual companies. With a large deductible program, the individual company is responsible for the losses less than or equal to the deductible amount for each claim. Anything beyond that deductible amount is transferred to the carrier. Typically the carrier is the first payer of the losses in these programs, and then bills the client for the amount that falls within the deductible layer.

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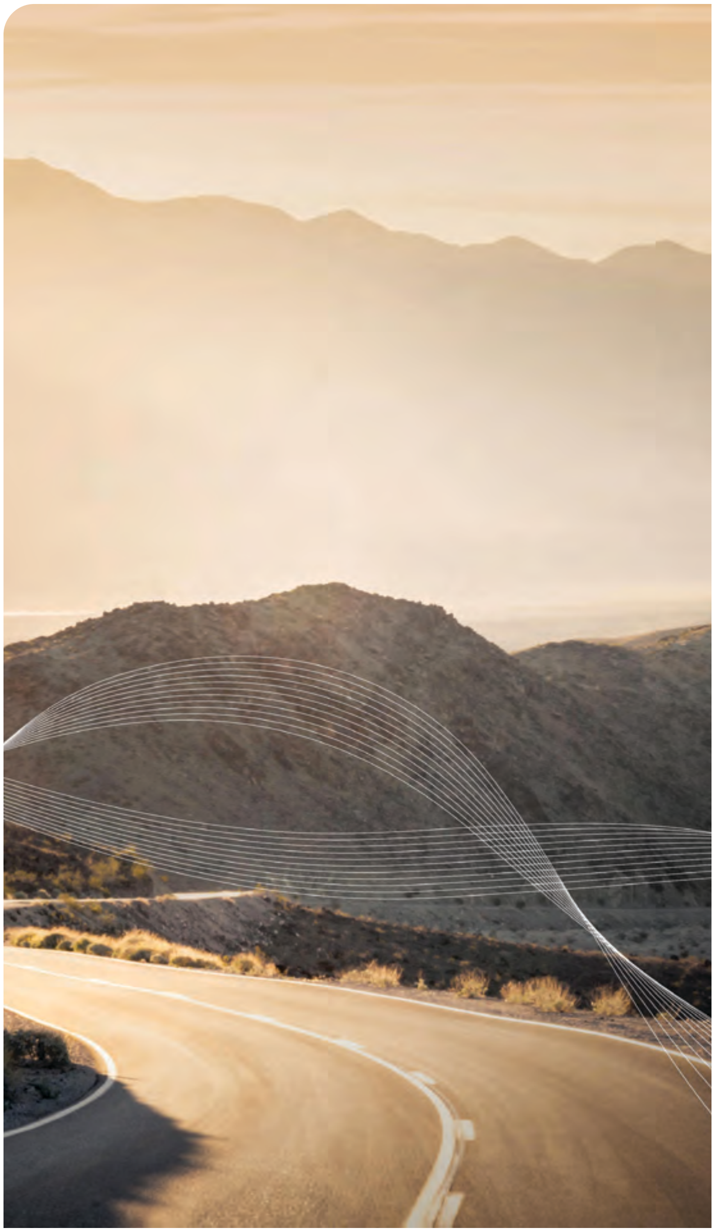
These programs are considered more risk taking, as the company is taking the risk individually and its financial success or failure falls on it alone. These are typically considered long-term programs, since they require collateral for credit risk each year the company is in the program and the length of time it takes to close the claims that occur.



5. SINGLE-PARENT CAPTIVES

Typically the advantages of a single-parent captive are:

- Flexibility to handle changing risk financing needs
- Development of tailored insurance policies
- Facilitation of business planning and cost allocation
- Potential to receive tax savings

Single-parent captives are wholly owned and controlled by the company, and are typically formed to insure or reinsure the risks of that company. These programs are at the top of the risk-taking pyramid, as the individual company is establishing a solution in which it is taking on the majority of the business risk within it and placing reinsurance coverage at a level above it in case of catastrophic loss. These setups are typically to self-insure P&C lines of insurance, as well as other coverages not always available in the traditional insurance market. In taking on the majority of risk, the company also takes on the majority of profit that would come from a favorable experience. These types of programs take the company out of the insurance market cycle for the most part. The main concern with single-parent captives is the point of entry; these are for large companies with large insurance risks that can afford the start-up costs of creating their own insurance vehicle. It is by far one of the most risk-taking avenues for a company but is also one for companies that are of larger size and scope.

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HIGH-LEVEL SUMMARY OF TARGET COMPANIES WITH FEATURES AND BENEFITS

Guaranteed Cost	• Risk averse • Unable to financially take risk	Soft market
Rent-a-Captive	• Interest in sharing risk • Easy entry and exit	Soft and hard markets
Group Captive	• Interest in sharing risk • Strong commitment to safety and good loss history	Soft and hard markets
Large Deductible	• Wants to take risk • Large companies with multistate exposures • Ability to provide collateral	Soft and hard markets
Single-Parent Captive	• Wants to take risk • Large companies with large risks • Strong risk finance acumen	Soft and hard markets

These are just a few examples of different programs that can be used by companies depending on their risk appetite. Each has its unique benefits and potential downsides, and is affected by the insurance market cycle in different ways. Company size and risk appetite are the best guides to which program best suits your company, in both the short and long term.

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THE ART OF RISK

At Artex, we believe there is more to alternative risk management. As a trusted leader and provider of diverse (re)insurance and ILS solutions, our global team operates at the intersection of art and science — where creative thinking meets expertise and superior outcomes are made. That's how we're able to fully understand our clients' needs and deliver the most comprehensive solutions available.

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