A BALANCE SHEET ACT

Assessing balance sheet risk tolerance and claims loss impact within a captive program to offset inflationary premium pressures

Jeff Kurz, Captive Insurance Specialist at Artex

Artex

Captive insurance — structuring and mechanics

Captive insurance (or self-insurance) involves the creation of a licensed and regulated insurance company domiciled in one of the 35 US states that have supporting programs, or via traditional offshore domiciles such as Bermuda, the Cayman Islands and Guernsey.

Technically, insurance is access to capital at a discounted rate. In the event of a claim, the claims loss is financed in part or whole by the paid premium, which generally covers the total insured value of the claim until the capital is no longer at a discounted rate. A captive is essentially a risk financing vehicle where the insurance transaction and the financing of that risk within the captive work hand-in-hand.

Risk tolerance increases proportionately with balance sheet strength, so an early assessment to determine how robust the balance sheet is when factoring in external market movement can pay dividends longer term. By enabling the owner to transfer balance sheet risk, a captive equips companies with increased control over their insurance and (re)insurance program structure and connected spend.

WHAT'S COVERED:

- The mechanics of a captive insurance program — access to capital, retentions and claims loss funding
- Self-insurance (captive) versus commercial market placement — offsetting market and pricing fluctuations
- Risk modeling and actuarial modeling to assess captive insurance structuring

PURCHASING INSURANCE ON THE COMMERCIAL MARKET VERSUS SELF-INSURANCE

Starting with the economics of the transaction, identify how much insurance you are buying and why you are buying it. At the same time, consider the option to retain risk via self-insurance in the primary layer and then look at ways to finance the remaining risk.

Therefore, when it comes to considering commercial market placement versus packaging risks within a captive, companies and captive owners have a series of connected and important decisions to make.

These include:

- Risk tolerance is a measure of risk appetite used to quantify the amount of risk that will be retained on the balance sheet over a specified time period versus risk transferred out to an insurance carrier in return for a premium. This is often linked to a portion of risk capacity such as capital at risk or earnings volatility.
- Having a clear strategy, including CAT and actuarial models, helps a client fully understand and evaluate the risk retained on their balance sheet via a captive strategy.
- Maintaining a loss fund for the risks that the client or company chooses to retain and having a clear strategy, including CAT and actuarial models, also help a client fully understand and evaluate the risk retained on their balance sheet via a captive strategy, or through a mix of captive and commercial market placement.
- Smoothing out volatility related to the retention of risk within the captive is a key consideration, particularly for publicly owned companies. Using the captive to smooth earnings and expense the premiums paid over time to the captive can help reduce volatility related to the earnings impact of a large-claims loss — in a specific year where it is more difficult to predict when that will happen — such as a cyber-attack event or extreme weather event.

BUILDING A HOLISTIC VIEW OF A BALANCE SHEET TO ASSESS RISK TOLERANCE AND STRUCTURING SELF-INSURANCE PROGRAMS

Companies and existing captive owners can take an enterprise-wide viewpoint when assessing foreign exchange markets, uninsured property and casualty (P&C) risks, and macroeconomic factors such as inflation, investment yields and supply chain disruption, and then establish how they all fit together.

As part of the risk tolerance and retention strategy considerations, a captive program offers a range of benefits and advantages, including:

- Having the flexibility to fold in other risks to balance retention, risk tolerance and the cost of premiums
- Packaging challenging and harder to place risks together to control loss for infrequent but higher-severity risks, which may involve a one-in-50-year event that could occur in year one
- The ability to manuscript a policy to incorporate all the terms and conditions the company needs, including whether a claim is included or excluded within the policy wording
- The option to adjust insurance deductibles to reduce premium
- Correlating investment and loss-prevention activities with what sits directly on the balance sheet
- Setting up a fronting company partnering with an insurance carrier to derive the full economic benefit of balancing risk retention in the captive. The insurance carrier issues a policy and transfers the risk back to the captive owner to satisfy regulators that the company has evidence of appropriate levels of cover, particularly where a captive owner may not be able to directly insure risks across multiple countries and jurisdictions

RISK MODELING AND ANALYTICS TO ASSESS CAPTIVE STRUCTURES

In the current market, companies need to be more analytically driven. Having the best information available including risk modeling and analytics is a prudent move, and demonstrates robust corporate governance to carriers and (re)insurers participating in placement discussions.

Jeff Kurz expands further on this point.

"As one example, companies using captive insurance companies to fund their General Liability and Workers' Compensation and employee medical programs have a clear advantage in terms of being able to add something like Commercial Property insurance or another more challenging risk class to the captive.

This is important, particularly for property insurance claims, which are generally viewed as infrequent but a potentially high-severity-driven event. Although it may be unlikely that a large loss will occur often, when it does, as in the case of a large factory burning down, the loss is a bigger ticket item than the compensation for an injured worker linked to the claim.

To optimize the value of the discussion, considering total insurance risks and connected external factors can be beneficial in presenting a more holistic view. These include supply chain disruption, import costs and controls, inflation, and exchange risk, through to uninsured property and casualty risks, and how those all interact with each other.

PAIRING AND PACKAGING RISKS TO SMOOTH OUT MARKET FLUCTUATIONS

Pairing a severity-driven risk such as Commercial Property with a more predictive risk such as General Liability (i.e., more frequent but less severity driven) financed within the captive helps balance the spread of risk to smooth out the impact of capital fluctuations within the captive.

The real benefit comes in a situation where, for example, the Commercial Property risk has a large claims loss and the captive owner is able to draw on dollars generated from the other lines of coverage that are currently profitable. Building the captive model with the flexibility to smooth expense from an enterprise-wide standpoint is one strategy that should be top of mind when structuring a captive solution.

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FURTHER INSIGHTS

UNDER PRESSURE

Capitalizing on alternative risk solutions in the face of a hardening Commercial Property market

Steve McElhiney,
SVP and Director of (Re)insurance

NATCAT STRATEGIES

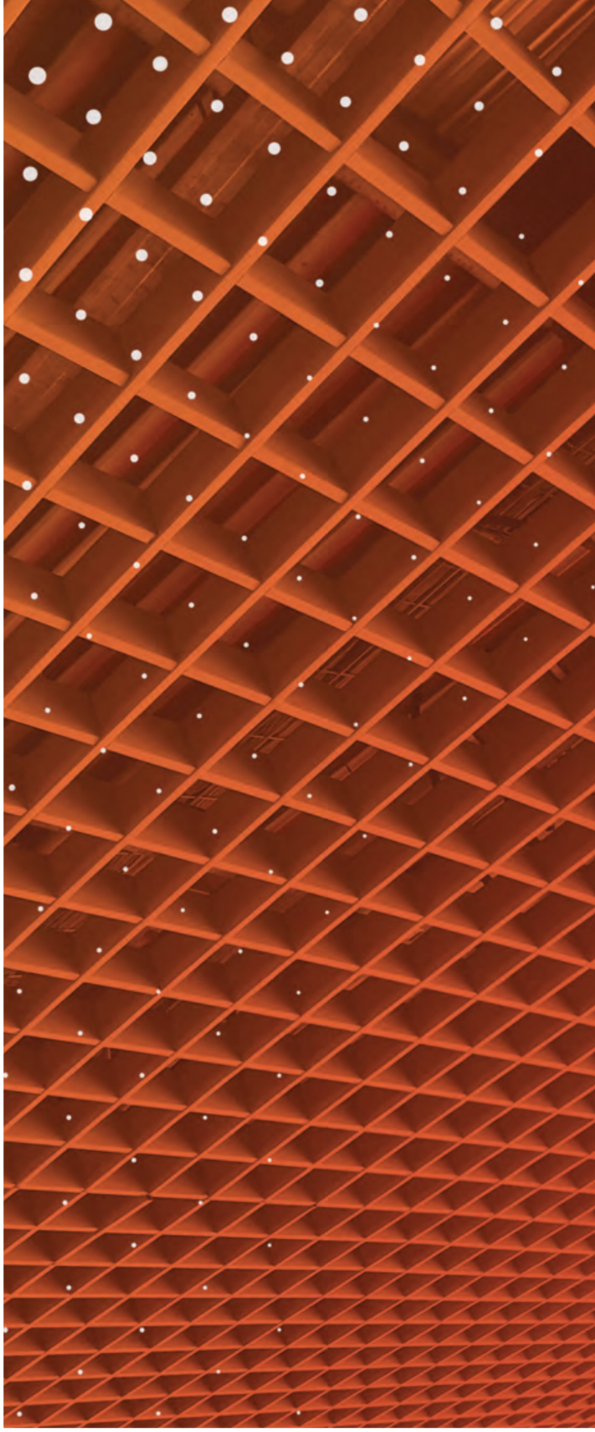
Structuring commercial property risks in natural catastrophe zones and offsetting extreme weather event exposures using alternative risk strategies

Steve McElhiney,
SVP and Director of (Re)insurance

JEFF KURZ

Captive Insurance Specialist at Artex

Jeffrey A. Kurz is the managing director of Captive Insurance Sales and Consulting for Artex Risk Solutions. He has more than 20 years of experience in the area of alternative risk financing, including work with captive insurance companies, segregated cell captive insurers, risk retention groups and self-insured trusts, with specific concentrations in healthcare, real estate and large multinational company related risk. He has formed a large number of captives in the major domiciles of Vermont, Bermuda and the Cayman Islands, as well as multiple other US states and foreign jurisdictions.



artexinfo@artexrisk.com
PHONE: +1.630.694.5050
PHONE: +44.(0).1481.737100
artexrisk.com

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