



## **Alternative Insurance Markets**

### ***Challenges and Opportunities for P&C Commercial Lines Carriers***

It will come as no surprise to P&C commercial lines carriers that, according to A.M. Best, roughly half of commercial premium has fled to alternative insurance markets since the 1960s, when regulatory reform in Bermuda gave a boost to the already growing interest in non-traditional methods of managing risk.

Among the reasons companies are resorting to alternative markets are:

- The desire to eliminate an insurer's profit margin and overhead from the risk management cost equation
- The need for risk management options during both hard and soft markets
- A belief that existing insurance markets are failing to recognize and/or to reflect in premiums a company's superior risk profile

Alternative structures take two main forms - those that retain and/or pool risk and those that fully transfer risk to a specialized third-party. The most common structures used to retain or pool risk include self-insurance, risk retention groups, and captives. These vehicles attempt to reduce volatility of large losses or reduce the overall cost of insurance without transferring risk to a wholly independent third-party. Although these structures originally targeted traditional lines of business (e.g., general liability, workers compensation, property, excess and umbrella), their market has expanded to include non-traditional lines as well (e.g., sexual misconduct, pollution liability, animal feed contamination, extended warranty coverage).

The most common alternative structures used to transfer risk include cat bonds, reinsurance sidecars, specialized reinsurance contracts and OTC derivatives. These structures all involve payment of an upfront "premium" in exchange for full or partial risk transfer, typically above a threshold amount. These structures often cover lower-

frequency/ higher-severity losses associated with a specific event (e.g., hurricanes) and are used to provide non-traditional reinsurance.

Regardless of whether one views the resort to alternative markets as inevitable or as a reaction to the failure of traditional carriers to evolve more effective methods of managing risk, what is clear is that carriers must have a strategy for dealing with the growing competition from alternative markets.

This month's *View from the Bridge* focuses on the captive sub-segment of the P&C alternative market space and the opportunities for carriers in it.

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### ***Evolution of the Captive Marketplace***

*"CFOs have come to view captives as a powerful tool in their ongoing quest for more effective methods of balance sheet management."*

— Michael Mead,  
President of M.R. Mead & Company LLC and  
Expert Commentator on Captives for IMRI.com 2009

A captive is an insurance company that is owned by a non-insurance parent (or parents) for the sole purpose of providing insurance coverage to the parent. Initial users of captives tended to be large corporations or collections of smaller organizations with similar risk profiles that, brought together, could expect to experience a relatively predictable pattern of losses. Accordingly, captives may have a single parent or multiple owners. Rent-a-captives and protected-cell captives enable smaller companies to rent the captive structure from a sponsor (e.g., an insurer or broker) without having to supply the upfront capital. In rent-a-captives, risks are pooled, while in protected-cell captives, the risks are segregated by company or unit within a company.

In addition to those benefits common to most alternative risk management vehicles (e.g., reduction or elimination of carrier underwriting profits as a cost to the insured), captives offer the potential for an additional set of benefits, including:

- Stability and predictability of year over year premiums to manage cash flows
- The ability to implement highly customized risk management programs

- Greater control over how funds are invested prior to their use to pay claims
- The ability to take advantage of the more favorable regulatory environment of domiciles such as Bermuda or the Cayman Islands
- Direct access to reinsurers and the ability to negotiate concessions

The number of licensed captives has grown at an average of 6.75% per annum for the last 25 years, through both hard and soft markets. In recognition, a number of states, including Vermont, South Carolina, Delaware, and Kentucky, have sought to attract captives and made significant changes to insurance regulations in that pursuit.

### **Implications and Opportunities for Carriers**

The risks for commercial lines P&C carriers in the drift of companies toward alternative means of managing risk in general, and toward captives in particular, are readily apparent. The opportunities are less obvious.

In our view, the carriers that will prosper are those that put the customer's interests first. This means that carriers should be prepared to identify those customers who would be better served by alternative means of managing risk and to advise them, involving brokers and other intermediaries as appropriate, of their options. It is in any case only a matter of time before a customer will discover for itself that better means of managing risk exist, and it will feel little loyalty toward a carrier for whom the relationship has been little more than a transaction. Having mismanaged the relationship, this carrier will be poorly positioned to provide the wide array of services that the customer will continue to need.

Among the products and services that carriers may provide to customers going the captive route are:

- **Fronting** — Captives often need an insurance company licensed in the state where the risk resides to write and issue policies, make necessary state filings, and pay premium taxes. The fronting company will then cede the entirety of the risk to the captive via a reinsurance arrangement known as a fronting agreement. The fronting company receives compensation for providing these services and, in addition, for the residual risk it will often assume should the captive for any reason prove unable to fulfill its obligations.

- **Excess Coverage** — Most customers will purchase excess coverage for losses that pierce working layers.
- **Claims Management** — The service that accounts for the bulk of the headcount in most insurance carriers is as necessary when a company chooses to form a captive as when it purchases insurance in the traditional manner.
- **Loss Control** — Enlightened companies have always valued loss control services, and the value they perceive is as great or greater when they are, directly or indirectly, responsible for funding losses themselves.
- **Actuarial Pricing and Reserving** — Captives may engage a third party to assist in determining premium levels consistent with projected losses and parent company goals, as well as in determining IBNR and making top-of-the-house adjustments to reserve levels.
- **Enterprise Risk Management (ERM) Consulting** — Though not directly related to captive formation or operation, ERM consulting represents another opportunity for carriers to provide services to companies no longer interested in traditional forms of insurance. ERM is the concept of measuring and managing all risks within and facing an organization. It involves the identification and quantification of both traditionally quantitative (e.g., commodity prices, interest rates) and qualitative risks (e.g., executive fraud, brand erosion). Strategies are then developed to manage these risks to an acceptable level. Captives can be utilized in a customized ERM program to actively manage these risks and facilitate reinsurance above agreed retention levels.

Providing captive services is not without risk, as evidenced by Markel's experience several years ago. In 2005, the Markel SMART (Specialized Markel Alternative Risk Transfer) product, focused on captives, risk retention groups, and self-insurance programs, was the fastest growing product line at Markel. By 2007, however, Markel discontinued the offering, stating that the "product line simply did not work. The most common problem was our delegation of underwriting authority to managing agents without, in hindsight, sufficient underwriting oversight."

## **Conclusion**

P&C commercial lines carriers may not be able to stem the tide of customers turning to captives and other alternatives to traditional insurance, but by behaving in an enlightened manner and putting the customer's interests first, they will retain for themselves a role as a trusted risk management partner and be well positioned to provide a wide array of products and services that will continue to be required for the foreseeable future.

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