

Captives Move to Center Stage as Risk Management Evolves

by Thomas P. Stokes

Not long ago, risk managers often chose captive insurance solutions in a knee-jerk reaction to commercial insurance options that fell short of their needs. Each time these insurers failed – witness workers compensation, product liability and medical malpractice – captives adapted to fill the void. When markets finally stabilized, the driver for the captive evaporated. As a result, captives often languished and the commercial markets counted on the return of premium from these alternative risk vehicles. Herein lay the inauspicious beginnings of captive insurance.

Risk Management and Captives Grow Up, Together

As with everything else, the world moves on, and so captives morphed yet again. Call them the Transformers™ of the insurance world, reconfiguring to meet the needs of their owners. This time the adaptation of captives combined with the evolution of risk management techniques to facilitate a whole new perspective on risk management.

Explosive developments in the dissemination of electronic data have taken much of the mystery out of the mechanics of insurance. The “black box” factor has largely been eliminated. Risk managers are now privy to the same data that was once the domain of actuaries and underwriters. The easy availability of information has allowed risk managers to better understand and compare their own risk with others.

During the 1990’s, a new breed of risk manager began to put this burgeoning wealth of information to work to help them understand, test and challenge underwriters, causing a good deal of pencil-sharpening come renewal time. Once these new risk managers found their “sea legs,” they began to challenge the old practices of simply allowing brokers to design their insurance programs. They set out to understand their risks and begin controlling them, often finding it better to retain some risk versus purchasing risk transfer. Perfecting these techniques gave risk management the potential to become a profit center. One could argue that these developments are a key factor in the continued malaise in the commercial markets. Knowledge really is power.

Another factor influencing the development of risk management techniques is the acceleration of globalization. Companies that might have, up until a few years ago, had virtually all of their operations situated in the US, soon grew to include risk around the world. Risk managers not only lived on airplanes, but bought local, disjointed and potentially expensive insurance policies just to comply with local regulations. Risk managers *needed* a way to consolidate these risks into global programs to bring costs under control.

As risk management techniques evolved, outside factors accelerated their importance and urgency. The passage of Sarbanes-Oxley made senior management more accountable for the financial information to which they attested, thus making risk managers focus on specific areas of liability. Shareholder involvement in setting corporate policy and responsibility led to lawsuits against board members and senior management. External factors like BASEL II, the attempt at uniform financial standards out of Europe, brought new focus on Enterprise Risk Management

(ERM). Combine all of these factors with the belt-tightening wrought by the economic collapse of 2008, and it is no surprise that the old way of managing risk had to change.

From Chaos, Order

Facing increased scrutiny and responsibility, risk managers had a choice – continue to rely on the old ways of buying whatever insurance the markets offered or take matters into their own hands. With more than 5,000 captive insurance structures in the world today, it's obvious which path many chose. Captives are time-tested, trusted and disciplined risk-transfer vehicles that are surprisingly versatile. Risk managers find that the flexible structures of the many captive options available are easily adaptable to individual company requirements.

As captive owners will attest after operating their captive for a number of years, the control they exercise over the cost of risk transfer is hard to live without. Owners are eager to secure profits with their captives that used to be lost to insurers. To be sure, negative development can always deliver the opposite results to a captive. Proper analysis, full understanding of the risks involved and an evaluation of the risk tolerance of the overall enterprise help to minimize these negative developments. Once again, knowledge is power. Captive owners don't advocate the elimination of commercial markets, just the limitation of their use to purchase risk transfer above comfort levels they – not commercial insurers – establish.

More and more, captives are becoming the vehicle of choice to not only fund retained risk, but to minimize the cost of risk transfer to lower-cost reinsurance markets anywhere in the world. Conservative estimates point to more than \$20 *billion* annually in premium being diverted from commercial insurance products to alternative risk structures, of which captives are the predominant component.

The best indicator that this is a disturbing trend for insurers is their increased interest in participating in the alternative risk arena. Many major insurers have established their own cell captive entities to entice clients to stay with their companies in hopes of maintaining some level of control over the purchasing decisions of risk managers. Other insurers have developed sales programs and marketers dedicated to providing insurance products to captives in the hope of recouping some of the profits now being lost to them.

An Indispensable Tool

Fast forward to today. The concept of using a captive for specific, troublesome risks not easily accommodated by insurers has been turned on its head. Now that businesses more fully understand their overall risk profile, it is logical to take a more comprehensive approach to determining what their tolerance for risk is and planning accordingly. More risk managers are using captives to house and fund risk first, seeking reinsurance opportunities only when risk levels exceed their tolerance for retention – the “captive-centric” approach.

Using a captive as a clearinghouse for risk has distinct advantages. It facilitates the evaluation of overall exposure to the enterprise, allowing risk managers to more effectively manage it. Risk managers are now better prepared to execute their responsibilities, including to:

- Identify and quantify exposures globally that would negatively impact the operation of the enterprise
- Control or limit those risks that can be impacted

- Determine which risks are best retained by the business
- Develop a funding program for retained risks to minimize impact to financial statements
- Purchase risk transfer for unpredictable and catastrophic risks that would impair the viability of the enterprise
- Report to management on the status of risk and the steps taken to eliminate or minimize it
- Conserve corporate resources

Think of a captive as a risk organizing and management tool (...“there’s an app for that!”). For each responsibility imparted to risk management, the captive provides the centralized vehicle for its efficient execution.

Management needs to know not only the risks that could impact the operation of their business, but what is being done to control them so that they can make appropriate strategic decisions about where to deploy capital. Without an accurate and comprehensive picture of risk, management could make the wrong decisions.

Utilizing the captive as the repository for risk provides for risk's identification and quantification in a financial format, easily comprehended by decision-makers. The captive’s implementation and ongoing business plan is written and continuously adapts as needed to reflect the posture of the enterprise toward risk and how to manage it. As an example, captive documents might indicate that risks within certain parameters (cost, severity, etc.) will be monitored *en masse* based on overall loss development, and a reserve amount identified and funded. Other risks might be specifically monitored with captive assets allocated to programs that minimize risk, such as safety programs, technical training and emergency procedures and equipment purchases. Reserves would be estimated and monitored to cover losses. Overall enterprise tolerance for risk, based on management philosophy and financial position, would be reflected in overall retentions set for the captive. Reserves would be established and funded to minimize impact of negative development on financial results.

Financial analysts favorably evaluate companies that have thorough, comprehensive plans to identify and manage their risks. Captives provide a centralized vehicle in a financial format that can provide comfort to analysts that proper actions are being taken by the enterprise.

No Mystery Here

It isn't surprising that captives have once again adapted into the vehicle of choice, just right for the needs of these times. Migration of focus from the mere purchase of insurance to the monumental task of managing enterprise risk has led to the inevitable conclusion that a central repository is needed to organize and manage the process of identifying, quantifying, minimizing, funding and mitigating it. Advances in risk management science, enabled by developments in communication and risk management techniques, and fueled by the financial meltdown, have empowered risk managers to take more control over the process.

Captives provide the ideal structure for these needs. Their lightly regulated and well-disciplined format delivers a time-tested methodology for implementing new risk management techniques. Established infrastructure provides established reporting tools in the language of management, allowing better utilization of information and resulting in better overall decision-making capabilities.

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