



Captive insurance company – a definition: An insurance company subsidiary designed to cover the risks of its parent organisation(s).

Captive insurance company case studies – the reinsurer's perspective

by **Kieran O'Mahony**

About the Company: United Insurance Company ("United") is a Cayman domiciled property, casualty, marine and alternative risk transfer reinsurance and insurance company. United provides re/insurance solutions exclusively to captive insurance company clients of Aon Global Insurance Managers (AGIM), worldwide. United has a Best's rating of A- ("Excellent") and has actively underwritten a worldwide book of facultative and treaty reinsurance as well as direct insurance business, since its incorporation and formation in 1975 in the Cayman Islands. United has subsidiary companies in Vermont, Luxembourg and Bermuda. United is owned by the captive insurance companies of a number of leading US, Canadian and European multinationals. Underwriting and insurance company management services are carried out under contract by Aon Insurance Managers (Cayman) Ltd. For additional information please visit: www.uicayman.com and www.aon.com.

Captive insurance company business has always been viewed by United as 'preferred' business. Simply put, organisations that are willing and able to retain risk in their own (captive) insurance company subsidiary, whereby their capital is exposed to the potential for loss, as well as for profit (let's not forget!), will normally have a materially different, and United would contend, better approach to risk management than those that do not take such risk. Simply put, they have "skin in the game". That is the primary reason why United solely seeks out captive insurance companies as its means for underwriting (reinsurance) risk.

United is domiciled in the Cayman Islands, the world's second largest captive domicile. This coupled with its ownership structure and its focus on the captive and alternative risk transfer market gives United an unrivalled insight into the captive 'universe'.

United works with recently formed captives to manage their transition to ever increased retentions over the medium to longer term. Indeed, for the nascent and the well established captives alike, it can aid them to cope with the often "knee-jerk" and (over)reaction of the insurance market. Even putting market conditions and levels of capitalisation aside, captives will have varying degrees of risk taking appetite when participating on their "parental" programme(s) – recently formed and by extension unproven captives tend not to wish to take on too much risk, too quickly.

Increased property programme deductibles

Corporates that are forced to take increased property deductibles, either through the occurrence of fortuitous and 'a-typical' losses on their own (parental) programme or because of market swings that are outside of their control, can be left with balance sheets that have excessive net financial exposure. These concerns are even more pronounced for those organisations that traditionally have had superior loss experience, who

meet Highly Protected Risk (HPR) standards and have a proven track record in both risk management and loss control techniques.

United can look beyond the market cycle(s) or that exceptional large loss, and actually focus on the organisation itself, its risk management philosophy, its loss prevention and loss control features, as well as on the risk manager. Is the risk manager/the organisation a 'risk-taker' or just another 'insurance buyer' who views insurance as a mere commodity where, in their mind, cheapest is best? If the latter, United will not work with them. If the former, United will help craft a solution to manage the transition to the increased retentions.

United's specialised captive property reinsurance capacity focuses on "buffer layer" protection. This is the risk area immediately above the captive retention and/or corporate deductible(s) and below the attachment point of the traditional/commercial market. United's goal is to present solutions that are tailored to an insured's unique needs.

In its systematic approach to creating a solution, United works with the risk manager:

- in (re) structuring a new insurance/reinsurance programme
- in forming a captive or cell, where none exist, to absorb the increased retention
- in providing reinsurance for the captive's retention and
- in issuing the insurance policy and/or reinsurance agreement(s)

In structuring these types of captive "buffer layer" protections, United seeks to partner with clients whose risk is superior, whose philosophy is long-term and who are committed to the captive/alternative risk transfer market.

To illustrate the point, United partnered with a large US-based storage company to help it manage a sudden and significant (and from a financial/budgetary point of view, unexpected) increase in its property programme premium and deductible. The insurance carrier, long involved in the



programme, subsequent to an exceptional and large loss, increased the policy deductible from US\$100,000 per occurrence to \$2.5 million per occurrence – and all just a couple of weeks before the insurance programme renewed. Faced with this daunting prospect, the risk manager quickly turned to the alternative risk transfer market for a solution. United was invited by, and worked closely with, Aon Global Risk Consultants in structuring an alternative solution for the policyholder. United concluded that the loss was not reflective of the risk management realities of the organisation, but was truly the exception and ought not to be viewed as the norm. United re-underwrote the programme such that the policyholder increased its policy deductible to \$250,000, and the newly formed captive wrote a layer of \$2.25 million excess of \$250,000 and reinsured to United a layer of \$2.0 million excess of \$500,000 from ground up (fgu). The incumbent insurance company continued on the programme, as an excess carrier, attaching above \$2.5 million (fgu). Over the next few years, the captive's retention within the first \$2.25 million expanded and United's layer correspondingly contracted until, with sufficient financial maturity and experience under its belt, the captive was able to make the decision to retain the entire \$2.25 million. (See Figure 1)

Analysing marine programme loss patterns

Using an example from the world of captive marine reinsurance to next look at the "United" approach, a significant Canadian based ore commodities miner and refiner, which was at the time a 15-year-plus client of United and whose programme for all those years was loss-free, experienced that exceptional large loss to its marine cargo programme. The vessel it chartered to transport ore extracted from its Far East mines to its Canadian mining facilities, sunk in bad weather off Tokyo Bay, with the loss of all cargo on board and regrettably, three crew members. This loss was followed soon after by two medium-sized losses, similar in nature. United reinsured the captive for 70 per cent of \$19.5 million excess of \$500,000, per conveyance. The 'traditional' market sitting beside United on a quota share basis had 20 per cent, with the balance retained by the captive as 10 per cent co-reinsurance participation.

United representatives worked with the company's risk manager to get to the root cause of the change in loss pattern. It transpired that a few months prior to the losses occurring, the ore company had changed the shipping line used to transport its cargo. Stacking and stor-

ing of the ore bags aboard ship by the operators of the new shipping line were found wanting and this was evidenced in the loss adjusters report. Heavy weather caused the inadequately stored bags to shift, ultimately resulting in loss of ship and, regrettably, life.

The traditional insurance company market's response was to seek to increase the captive retention to \$5.0 million (from \$500,000) and increase rates by over 66 per cent. United, on the other hand, knowing and having worked with the client closely for many years, suggested a change in shipping line (which was accepted by the risk manager) and initiated full surveying of the loading and storing procedures on all new shipments. The captive did increase its retention, but to a more manageable \$750,000 and a modest but more financially realistic increased premium was charged. United was more than happy to continue as the lead reinsurer on the restructured programme. The traditional market quota share reinsurers stayed on the programme but reduced their participation considerably, which meant that the captive expanded its co-reinsurance participation and was augmented by sourcing additional traditional capacity. In the loss-free years that followed it became evident that the 'problem' had indeed been fixed. The traditional market tried unsuccessfully to expand its participation

on the programme, only to have its overtures rebuffed by the (still very grateful) risk manager.

Cell company solutions

United also has two 'cell' company subsidiaries – United SPC, in the Cayman Islands, and United USA, domiciled in Vermont – to work with those clients that are in immediate need of a captive solution but perhaps without the lead-in time

required to establish their own captive insurance company subsidiary. Cell companies are a form of 'rent-a-captive' that provide legal and financial 'fire walling' of assets and liabilities within the corporate structure, but most importantly, provide some of the benefits of captive ownership without the same financial, intellectual and management commitment required of a wholly owned captive subsidiary – rather like renting a condo as opposed to buying a home. Both cell companies



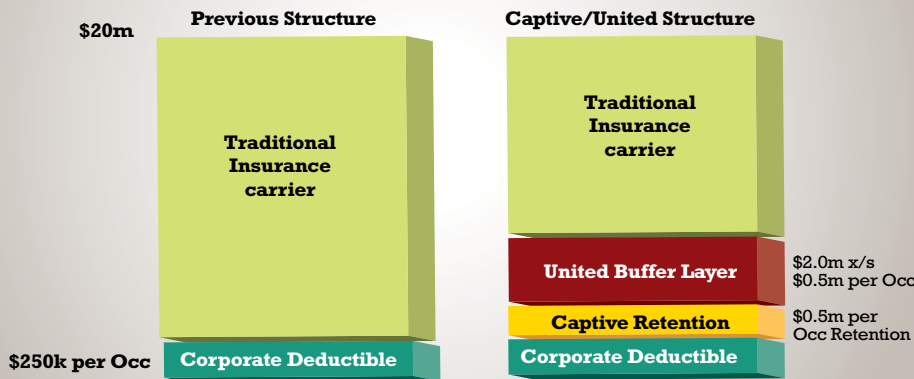
UNITED INSURANCE COMPANY

Figure 1

Property "Buffer" Layer

Global information storage company

Property Programme



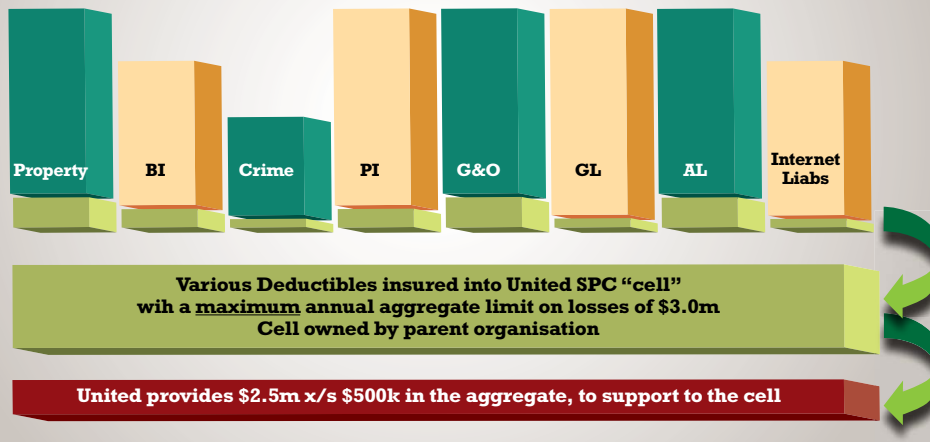
New Captive formed – Indicative Terms included in Feasibility Study

UNITED INSURANCE COMPANY AND UNITED SPC

Figure 2

Example of cell company structure

Multi-Line Deductible Buy-Down – Power Distribution Company



referred to above have provided tailor-made solutions to clients that were not part of the alternative risk transfer market. The following is but one example of the 'United' approach.

This example concerns a regulated entity in the United States of America. The occurrence of the 9/11 tragedy and consequent insurance market loss and classic "knee-jerk" reaction not only resulted in an increase in the US-based power distribution company's insurance premium, but also, for the first time, the imposition of policy deductibles on its insurance programmes. Under its charter, the regulated entity was required to pass on the cost of its insurance programmes, as an expense, to its end customers. The problem facing the power distribution company, given the imposition of significant policy deductibles, was that if/when claims were to be made under its insurance policies, the loss amounts associated with any of the now significant policy deductibles could not be passed on as an 'expense' to the end consumers. Further, policy deductible amounts were not recoverable at the corporate level. Thus, the power distribution company could be left with financial loss at the organisational level, something that was prohibited under its charter.

United helped construct a new insurance programme, whereby one of its subsidiary cell companies United SPC, domiciled in Cayman, issued a multi-line deductible reimbursement contract covering the deductibles of the separate lines of risk – property, crime, professional indemnity, directors & officers, general liability, auto liability, internet liability etc.

United developed a premium for the deductible reimbursement contract and also included an annual aggregate limit of \$3.0 million on the contract. The retained net premium in the cell, coupled with the cell's capital enabled the cell to retain up to \$500,000 in losses annually. United SPC, on behalf of the cell, reinsured an aggregate excess of loss layer with United Insurance Company for \$2.5 million in the annual aggregate excess of \$500,000 in the annual aggregate.

By utilising this approach, the client's "deductible exposures" were converted into "insurance premiums", which in turn were passed on as an insurance expense to the entity's end customers. The entity was not left with an insurance exposure for which it wasn't covered and thus the client and its Directors and Officers, were prevented from falling foul of its Charter obligations.

Over the following years, the profits built up in the cell meant that the aggregate reinsurance limits purchased by the cell declined and finally the need for reinsurance fell away as the cell was financially capable of retaining all of the risk. (See Figure 2)

By choosing its business partners wisely, by having direct access to the key corporate decision makers such as risk mangers and chief financial officers, by being able to present, in conjunction with Aon Global Risk Consultants, optimum solutions to captives' real and present needs, United has successfully fulfilled the requirements of its shareholder and client base worldwide, from George Town, Grand Cayman, for almost 40 years.

BIO: AT A GLANCE

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