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Downturn fuels change in mindset

Carl Daly argues that it makes sense to house newly assumed risks in a suitable vehicle, such as a rent-a-captive.

The current market turmoil has led to significant change across the globe as companies are being forced to rethink the way they do business.

This change in the corporate mindset will also have a significant impact on the buying patterns for insurance. Risk managers will certainly be evaluating an increasing variety of options in their pursuit of the optimal risk protection programme for their company. In these cost-cutting days, they will also be asked to show that they have played their part. Everyone is being asked to tighten their belts.

Companies will be re-evaluating who they do business with and how that business is done. Greater emphasis will be placed on financial security and corporate governance of all counterparties. Companies' risk focus will expand to encompass the broader concepts of enterprise risk management, incorporating the financial, strategic and operational risks that every company has a heightened awareness of.

Oversight of risk within companies will expand as regulatory bodies and investors scrutinise companies' risk management policies and procedures. Preservation of capital will be the driving force, with company survival being paramount.

The assumption of risks with high severity and loss frequency characteristics, unless capacity disappears, will continue to be avoided or transferred to the traditional insurance market. However, without doubt, there will be an increase in risk retention as buyers realise that, for many classes of risk, this is the best way to achieve premium savings. Premium savings will do more today for a risk manager's credibility within their organisation than improvements in loss ratios through good risk control measures did yesterday.

In spite of the large number of captives globally, many companies have managed their risks quite adequately without having to resort to forming their own insurance subsidiary. However, as retentions increase, it makes sense to house these newly assumed risks in a suitable vehicle. If a captive is not for you due to the high cost, or simply due to the time and resources required to satisfy the compliance issues, it may make sense to use a rent-a-captive as the vehicle to hold these risks.

Rent-a-captive facilities can be found in many onshore and offshore locations. There are currently in excess of 40 locations claiming to have the wherewithal to manage your captive business. All have dedicated legislation applicable to the formation of captives, but when it comes to appropriate infrastructure, as well as state-of-the-art rent-a-captive legislation, the list shrinks significantly.

The current structure preferred by buyers is the protected cell or segregated account facility. This is where the assets and liabilities of cells or accounts are legally ring-fenced, separated from both the core capital and the assets and liabilities of other cell or account owners. Bermuda and Delaware are examples of domiciles with appropriate legislation for these vehicles. Regulators in both these locations closely monitor changes in the market and, if required, are not reticent about improving and enhancing their laws.

In line with the expansion of 'Know Your Customer' practices to 'Know All Counterparties', it is important to ensure that buyers evaluate a rent-a-captive facility's capability, credibility and security. You must be confident that you know your business counterparties.

Even in these turbulent times, the rent-a-captives owned by highly rated multinational insurance carriers have the best story to tell:

1. Managing your account will be a logical extension of their primary business
2. In many cases, one or more insurance companies within the group will be able to provide fronting capabilities in conjunction with, or as an adjunct to, the rent-a-captive capabilities
3. Corporate governance will be of the highest standard
4. You will be given access to in-depth insurance expertise.

A rent-a-captive can complement an insurer's risk-bearing capabilities and can be a valuable tool in helping to structure a programme to meet the buyer's needs. A rent-a-captive facility can be used for all the standard traditional coverages that are the main focus of wholly owned captives. However, they can also be used in unique circumstances to solve risk financing issues. Even current captive owners may see the benefit of segregating certain risks from their main portfolio.

Examples of these unique circumstances might include:

- An acquiring company wants to buy an entity but is only interested in the going concern, not the entity's past liabilities. A vehicle may need to be found to house the legacy risks. A rent-a-captive might be a solution if adequate funding is available and potential losses are capped
 - Partners in joint ventures may mandate that full insurance must be purchased for the joint venture rather than simply extending existing programmes for each partner's respective shares. A segregated cell in a rent-a-captive might be used to fund all the potential self-insured exposures of the entire joint venture
 - Companies may decide to switch their insurance carrier due to security fears, but remain concerned about the longevity and ability of former carriers to adequately cover the residual risks related to expired long-tail coverages. A loss portfolio transfer to a rent-a-captive would ease these concerns
 - If insurer security concerns and reducing capacity lead to programmes being restructured on a subscription basis, with a greater number of carriers taking smaller shares of the risk, it would be easier for insureds to cover any gaps by utilising a rent-a-captive segregated account structure.
- No one can foresee with certainty how the current economic crisis will affect each insured's specific requirements. A self-insurance vehicle, such as rent-a-captive structure, may be the optimal solution as it provides insureds with a measure of control over their own business requirements. The cost of risk is on the rise. Historically, this has led to companies wanting to retain more of their own risk. For those insureds that do not have a captive, a rent-a-captive can be utilised quickly and is a low-cost way to self-insure.
- Tight credit markets and increased regulation may mean that now is not the time to seek approval for setting up a wholly owned captive insurance company with its additional administrative burden and cost. A rent-a-captive structure can provide a less expensive alternative, while providing an insured with the same benefits
 - Terms and conditions will tighten: A rent-a-captive structure is a way to insure risk that the traditional insurance market finds unattractive
 - Tailored policies: These are not typically found in the traditional insurance market. Using a rent-a-captive structure is a way of tailoring the coverage to meet your needs.

The current market changes will certainly bring new challenges for buyers. Many will be looking for insurers to provide a complete solution. In many circumstances, your needs and the insurer's risk appetite may not be in sync. A joint approach between insurer and insured, utilising a rent-a-captive, might be the right solution.

The use of captives and rent-a-captives is not new. However, in times of change, things that were once old will become new again. The beauty of using a well-managed rent-a-captive, as opposed to forming a wholly owned captive, is that the client can achieve the same benefits but with less time, cost and complexity.

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