ALESCO

RETAINED RISK

Retained Risk Financing Narrative

When a company is considering the best way to manage their retained risk, there are a number of different approaches available to them:

1. Pay as you go
2. Facultative (Re)insurance
3. Captive (or one of the captive variants)
4. Retained Risk Financing Plan
5. Insurer Captive Replacement Programme

PAY AS YOU GO is no more than paying losses out of operating revenue as and when the losses fall due for payment. This approach is the most economic if there are no or minimal losses. However, should significant losses materialise; this introduces significant volatility into operating cash flows and the budgetary cycle. Losses retained in this way have no tax deductibility and no transfer of risk.

FACULTATIVE (RE)INSURANCE provides real risk transfer and has a known upfront cost. This approach can prove an expensive route and there is no profit sharing mechanism in the event that losses do not materialise or are lower than expected. Additionally, facultative policy terms are typically 12 months, so renewals can be subject to significant pricing uncertainty of the insurance cycle.

CAPTIVE (OR VARIANTS) These are now well-established and recognised vehicles for managing and financing a company's risk. The downside to captives is the opportunity cost associated with tying up valuable capital as well as the increase of management workload and other soft costs. In addition, the legislative/regulatory environment (e.g. tax, accounting, reputational etc.) surrounding corporate offshore vehicles can dissuade some companies from following this course.

RETENTION FINANCING PLAN (RFP) Multi-year (re)insurance contracts with a profit sharing element can provide a flexible approach to retained risk. 'Finite' (re)insurance (to use the generic name for these structures) is a legitimate mechanism to finance and transfer risk provided the appropriate accounting conventions are followed. This approach can provide budgetary and cash flow stability over a comparatively long period (3 – 5 years) with the added benefit, if required, of being able to include risks that may be uninsurable in the traditional market. Depending on type and structure, substantial profit sharing arrangements of between 80 – 95% are possible and can include a significant element of risk transfer to (re)insurers. This option provides a balance of risk transfer and risk funding and tends to promote real alignment of interest between insurer and client.

INSURER CAPTIVE REPLACEMENT PROGRAMME This provides the key benefits of the traditional captive without some of the drawbacks. It avoids the need to establish an insurance company and the associated costs of management & audit as well as input of valuable capital from the parent. It provides licensed and rated paper which most captives do not achieve. However funds are at risk from potential insurer insolvency.

RETENTION FINANCING PROGRAMME

Whilst each client's programme is specifically tailored to their situation, the underlying mechanics of an RFP programme are similar. When designing and structuring these programmes, appropriate consideration needs to be given to the regulatory, tax and accounting implications. More importantly however, is the underlying commercial viability of the deal – if a commercially viable deal can be arranged, then, at that point, regulatory, tax and accounting treatment needs to be addressed by the client's auditors and legal counsel.

Typical policy periods are between 3 – 5 years. The policy will have both an annual and term aggregate limit – the most that can be collected in any one year and over the full term of the contract. These programmes are best suited to companies who have a sophisticated risk management framework in place and are prepared (or required) to accept a significant self-insured retention from their traditional lines of (re)insurance.

A percentage of each annual premium will accrue to an Experience Account (EA). This can either be a real account in the name of the (re)insured or a notional one held by the (re) insurer on behalf of the (re) insured. The Experience Account Balance (EAB) will continue to accrue with the payment of each annual premium payment. This plus a credit for investment income/interest on the positive balance are available to pay any claims that are incurred.

However, it is likely that there will be losses on this account. The following is an illustration of how the EAB would operate where there were annual losses of US$13m, US$5m and US$5m, half way through each year respectively, and in particular, a bad year.

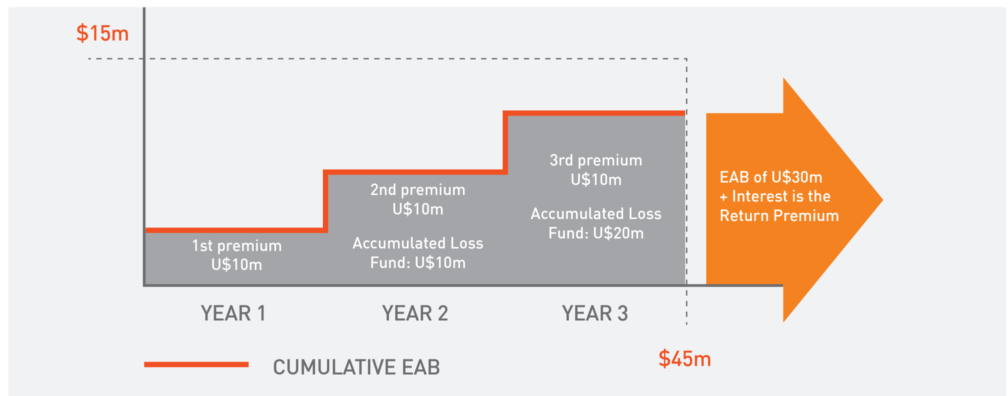
In the event that the EAB goes into a deficit position, the (re) insurer may require acceptable collateral (i.e. Letter of Credit) to decrease the credit risk against the payment of future premium instalments.

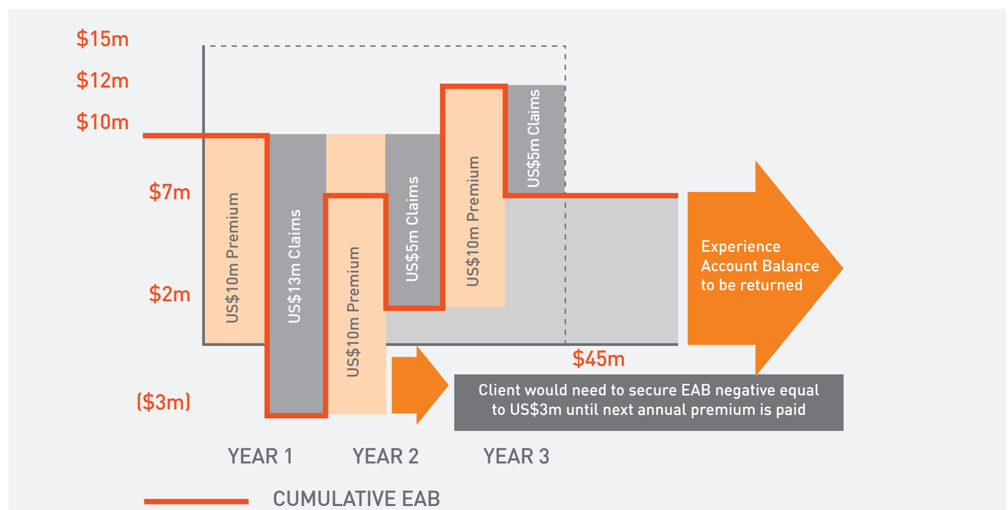
DEAL SUMMARY

TERM	3 years
LIMIT	$15,000,000 each and every loss, US$30,000,000 in the annual aggregate, subject to a term aggregate of US$45,000,000
ANNUAL PREMIUM	US$12,500,000 per annum
EXPERIENCE ACCOUNT CONTRIBUTION	80%

EXPERIENCE ACCOUNT BUILD UP

The illustrations below show how the EAB builds up over the course of a 3 year period. This is notional and based on no losses. At the end of year 3 with full and final settlement and release of liabilities commuted, the total positive amount of the EA, including investment income/interest (in this case it would be US $30M + interest) would be returned to the client.





WORKING EXAMPLE

A client purchases a 'cross-class' aggregate policy of U$100,000,000 any one occurrence/ U$200,000,000 in the annual aggregate to sit excess of its Captive Retention of US$2,500,000 any one occurrence/U$15,000,000 in the aggregate. Due to a cyclical 'hardening' of rates in traditional (re)insurance market, premium rates rise significantly across the board, regardless of the clients' excellent loss history. Rather than accept the indiscriminate rate increases, they decide to increase their retention to a level where the ongoing premium rate is less affected by the cyclical increase, and try to purchase 'in-fill' policies. The quoted premiums for these separate 'in-fill' policies from the traditional market are approximately U$13m per annum without any profit sharing and/or no claims bonus.

In this instance, the purchase of a RFP policy achieves two things. Firstly, it enables the client to use the traditional market where it is truly cost effective to do so i.e. at an attachment point normally unaffected by attritional losses therefore creating less volatility around pricing. Secondly, it resolves an issue of local policy issuance, as the RFP carrier is able to 'front' for the programme where licensed paper is required e.g. EL and Motor.

Using the below example, the client could expect to receive 90% of the balance of the EAB upon commutation of the policy in return of the Experience Account Balance.

TERMS OF THE RFP POLICY

TERM	5 years
LIMIT	$25,000,000 each and every loss, US$37,500,000 in the annual aggregate, subject to a term aggregate of US$75,000,000
ANNUAL PREMIUM	US$10,000,000 per annum
EXPERIENCE ACCOUNT CONTRIBUTION	90%

BENEFITS OF AN RFP POLICY

Entering into a RFP transaction may give rise to several potential benefits:

- Up to 80% – 95% of all premiums paid (or 100% of the EAB), plus accrued interest at an agreed rate, can be returned to the client in the event of minimal or no losses
- As the programme is non-cancellable by underwriters but commutable by the client at, following, its second anniversary, this provides continuity and stability in the risk management of risk exposure. Provides 3 – 5 years of certainty irrespective of record
- It provides cost and therefore budgetary certainty for three years
- If the anticipated level of attritional losses deteriorates, provides management with time to re-engineer/restructure programme on a more sustainable basis
- It promotes and encourages a focused and disciplined risk management culture
- Allows the risk management function to demonstrate further 'value added'. i.e. significant financial benefit if claims are reduced
- Provides highly rated (re)insurer paper (A- or better) for the policy
- Can be placed as a reinsurance of a captive, thereby providing the vehicle with 'synthetic' capital
- Provides a long term period of price stability in the most difficult primary area.

LONG TERM STRATEGIES

Once RFP programmes have been in place for a period of time (2 – 3 years) a detailed review should be undertaken to determine whether the programme is performing as intended. Some issues that should be examined are:

- Is the RFP still required? Or has it served its purpose?
- Should the company continue to purchase RFP insurance/reinsurance as a means of providing an efficient risk financing mechanism for its self-retained exposures but as a means of providing 'real' capital for a Captive/PCC
- Should the EAB that is available for distribution back to the (re)insured at the end of the policy term be taken?
- There may be tax implications if it is
- If the funds are to be used as risk capital this might allow a greater level of risk retention and or other types of risks to be covered (see below)
- Using EAB to run additional exposure would be attractive as it would reduce/negate any additional capital input from parent company
- Should the EAB proceeds be returned to the parent company? If so what is the most tax efficient way to do this?
- Any surplus EAB could be used to post collateral for other purposes (mine rehabilitation, closure/post closure exposures, captive fronting requirements etc.).

CONDITIONS AND LIMITATIONS

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MARTIN EMKES

Direct: +44 (0) 207 204 1815
Email: Martin_Emkes@alescorms.com

SUSAN WRIGHT

Direct: +44 (0) 207 204 1835
Email: Susan_Wright@alescorms.com

ALESCO

67 Lombard Street
London
EC3V 9LJ

Tel: +44 (0)20 7204 8999

www.alescorms.com

twitter.com/AlescoRMS

linkedin.com/company/alesco-risk-management-services

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