TREASURE THE CAPTIVE

WEB-BASED SOLUTIONS CAN HELP MAKE IT EASIER TO MANAGE AND ADMINISTER CAPTIVE INSURERS AND PROVIDE A HIGHER QUALITY OF INFORMATION, SAYS **SIMON PLUMRIDGE** OF SPEEDCLEAR.

Insurance is increasingly becoming part of the treasurer's responsibility, as hedging and insurance blurs, and as their skills in financial risk management are applied more widely for the benefit of the organisation. Companies typically centralise the purchase of insurance in order to achieve economies of scale and a co-ordinated risk management strategy. One key challenge is finding the optimum balance between retaining risk within the business and transferring the risk to an insurer. Insurance premiums are reduced if a company elects to retain more risk, and this is most conventionally done through a policy excess.

Many larger corporations, however, elect to retain risk through a captive insurer which is a subsidiary of the parent company. This captive insurer typically only accepts risks that are faced by the parent and will be based in a tax-efficient environment such as Bermuda, Guernsey or the Isle of Man. The parent therefore pays premiums to a subsidiary company, which may be able to earn investment income that is taxed at a more favourable rate than the parent company.

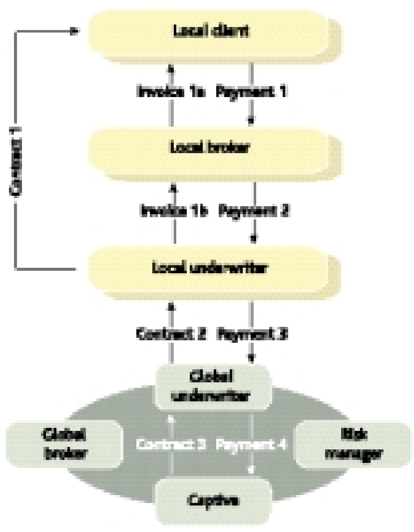
EFFICIENCY. The captive insurer will need to control the individual and aggregate exposures it takes on. This frequently involves limiting the exposure that the captive accepts to a fixed amount. It accepts a premium of, say, £750,000 to underwrite an aggregate claims limit of £1,000,000 in any one year. The captive insurer will seek to offset the balance of the exposure through income earned on the invested premium. One of its key aims therefore is to collect and invest premiums as efficiently as possible.

Additionally, the captive insurer will want to minimise administration costs. Companies frequently outsource the management of the captive insurer to access insurance expertise, while maintaining flexibility and minimising costs. The captive typically acts as a reinsurer to further reduce administration. As a reinsurer, there is no need for the captive to invoice and collect premium from each of the company's subsidiaries. More pertinently, if the firm is a multinational, a reinsurer does not need to secure underwriting licenses to satisfy regulatory requirements that commonly apply to primary insurers worldwide. This solution can, however, lead to complicated premium collection methods (see *Figure 1*).

The local underwriter issues a policy to each local client (often through a local broker). The local underwriter then re-insures most of the risk to the global underwriter, who subsequently reinsures an element of risk to the captive. The premium flow through this contractual chain frequently takes up to six months or more to reach the captive. Payment status is opaque and there is significant duplication of communication and reconciliation effort.

FIGURE 1

A TYPICAL PREMIUM PAYMENT ROUTE.



Although there are various premium payment routes, the treasurer's aim remains to move premium from each insured subsidiary through to the captive as quickly as possible. The premiums involved can be significant and cashflow efficiency can make the difference between a profit and loss for the captive.

Legislation in many countries further complicates the process of captive premium collection. The amounts that local subsidiaries actually pay are unclear at the outset, as surcharge taxes are added to allocated premiums paid to local underwriters. Furthermore, in some instances, deduction taxes, paid by insurers locally, will erode the amount of premium available to flow back to the global underwriter and on to the captive.

The process of managing this captive premium collection is hampered still further, since lines of communication are convoluted and it is not possible to get real-time status information throughout the process. Underwriters and brokers are working together to produce reports that are often out of date before they are issued. It should also be recognised that the opaque nature of global premium management currently enhances the opportunity for brokers and

TABLE 1

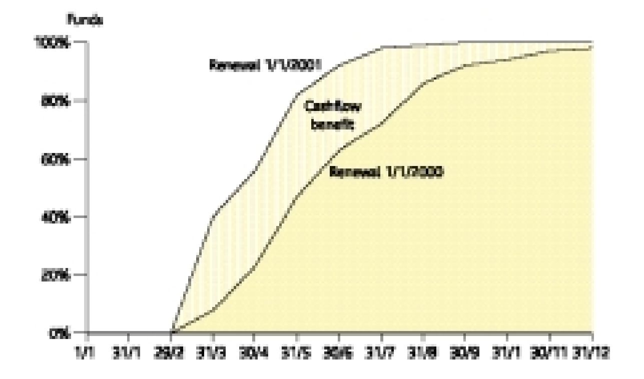
EXAMPLES OF TAXES AND CHARGES.

Subsidiary	Local currency	Client payable	Surcharge taxes	Allocated gross amount	Fronting fee 5%	Brokerage 15% premium	Deduction taxes	Net premium	Premium global underwriter	Premium to captive %	Premium to captive
ABC (1)	US$	1,025	25	1000	50	150	100	700	700	50	350
ABC (2)	AUS$	2,575	175	2400	120	360	200	1,720	1,720	50	860
ABC (3)	JP¥	860	60	800	40	120	80	560	560	50	280

The allocated gross premium (AGP) is the amount agreed by the client and underwriter for each subsidiary. Surcharge taxes are added to the AGP to generate the client payable amount. Deductions may include the fronting fee, which is the charge taken by the local underwriter to administer the policy, brokerage, earned by the insurance broker locally, and deductions taxes paid by the local underwriter. The net premium due to the global underwriter reflects these deductions. The premium to captive is usually a function of the net premium and paid in agreed captive currency. The acceleration of the collection reduces the exchange rate risk.

FIGURE 2

CAPTIVE FUNDS RECEIVED.



underwriters in the payment route to earn investment income at the expense of the captive (see *Table 1*).

These circumstances are significant barriers to the operation of an efficient captive insurance programme. Captive investment income is threatened, as the premium collection process is difficult to manage. As a result, it is not unusual for captive premium collection to take six months or more. Furthermore, the high administration costs for the underwriters are inevitably passed on to the corporate.

Two examples illustrate the difficulties faced by large multinational corporations and their underwriters in this regard. In one instance, the captive is paid a deposit premium of 60% three months after renewal, with an adjustment being paid after 12 months. In the second case, the subsidiaries of the corporate are invoiced three months before renewal to ensure that the appropriate premium reaches the captive in a timely fashion. These 'workaround' solutions are borne out of frustration and the process remains a source of friction between corporates and their underwriters.

In addition, a number of unilateral solutions have been devised in conjunction with particular underwriters. For example, the broker may be removed from the premium payment route. Other underwriters have agreed to fund the captive premiums from the premium received from one or two large subsidiaries or countries where premium payment can be monitored more easily. Other underwriters provide a fast-track payment system that will operate in certain territories with high premium volumes.

Although these solutions can move some way towards meeting the challenges that remain inherent in the system, they will often leave a treasurer with information on some policies and not others, or with information in a series of different formats.

Figure 2 shows the cashflow benefit is the area between the premium funds received lines, which are expressed as a percentage of the total expected captive premium at each month end.

A CHAIN REACTION. The tragic events of 11 September have had a profound effect on the insurance market. Significant premium increases and higher corporate risk retention is leading to an increasingly important role for the captive. Underwriters are also imposing premium payment warranties. These stipulate that premium must be paid within a certain period, for example, 30 days, and failure to comply may lead to policy cover being withdrawn.

Insurance market conditions have also encouraged some underwriters to move towards the central collection of global insurance premiums. Where legally possible, corporates make a central premium payment to the global underwriter on behalf of their subsidiaries. Cashflow to the captive will be eased where premium is paid in this way. Some subsidiaries, however, are likely to reside in territories where legislation dictates that premium must be paid locally. As a result, this is a partial solution as far as the captive is concerned. Furthermore, this benefit is counter-balanced since the corporate treasury department takes on additional administration work in recovering premiums from their subsidiaries.

Underwriters and brokers are making efforts to provide improved levels of management information to their clients. There is a growing recognition that the insurance industry needs to create a new level of transparency when dealing with key customers and with it an increasing acceptance that improved technology is a pre-requisite.

In response to this trend, we are now seeing the development of solutions designed to accelerate the global premium collection and distribution process. They can provide interested parties with management information that helps to create an environment where every aspect of the premium management process can be improved. The optimum solutions are those web-based collaborative offerings that facilitate efficient communication between the treasurer, broker and underwriter in this complicated arena.

Treasurers are accustomed to making decisions with high quality management information at their fingertips. Those who have responsibility for captive insurers should challenge their underwriters and brokers to meet this expectation.

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