COPING WITH THE UNEXPECTED

ALTERNATIVE RISK TRANSFER SOLUTIONS CAN HELP REDUCE THE DEVASTATING EFFECT UNEXPECTED LOSSES CAN HAVE ON A FIRM'S FINANCES. **PHILIPPE GOURAUD** OF AIG DELVES DEEPER.

A large loss can have a severe impact on a company's cashflow and financial statements. Therefore, firms seeking to reduce the damage a material loss can cause to their business may find it valuable to investigate the role alternative risk transfer can play in managing the risk of these losses.

TODAY'S INSURANCE ENVIRONMENT. In today's insurance market, many companies have been placed in the unenviable position of retaining higher levels of risk through increased retentions – or by virtue of the fact that many coverages simply are not available at an acceptable price. As companies adjust to the severe reduction of insurance capacity, many must prepare to absorb losses they were previously transferring to the conventional insurance market.

The good news is that, for healthy companies, even a large uninsured or underinsured loss may be manageable over time. But the bad news is that insurance losses rarely occur 'over time'. A loss that a company may have the financial strength to withstand over the course of a year or more can create havoc when its impact is felt in a single quarter.

Unfortunately, catastrophic events, such as major litigation or a rash of claims for occupational injury, occur unpredictably. Therefore, the dilemma facing companies is not so much a question of whether a loss will occur, but when and of what magnitude. This is the essence of volatility risk. A catastrophic loss primarily affects a company in two areas:

- profitability can be impacted by the occurrence of a large unforeseen event; and
- cashflow can be altered by a large, immediate payout.

Such adverse, unanticipated events can affect the company's share price and undermine investor confidence. The cashflow effect may require a firm to liquidate investments or use a credit line, invoking not only the initial loss, but also the costs that may accompany an unpredictable immediate need for cash. This risk remains considerable, whether assumed directly by a parent company or through a captive insurer.

WHAT IS A 'CAPTIVE'?

A captive is an insurance company that is created and wholly-owned by one or more non-insurers to provide its owners and their subsidiaries with insurance coverage. It is a form of self-insurance that may encompass any or all of the insurance needs of a particular company. A captive functions as any other (re)insurance company: assessing and assuming risk, paying claims, and complying with the full range of statutory requirements, where applicable.

USING INSURANCE TO REDUCE VOLATILITY. Alternative insurance solutions that can mitigate volatility resulting from unexpected losses are offered in two forms:

- structured insurance programmes for prospective exposures; and
- liability buyouts for retrospective exposures.

Structured insurance programmes help manage a company's exposure against certain types of volatility, both from a cashflow and a financial statement perspective. By transferring risk through a structured programme, a company is able to stabilise its cash outlays and possibly protect itself against a future significant loss that could disrupt results for a quarter. Simply put, while you cannot schedule the timing of a loss, you can schedule the timing of premium payments.

'ALTERNATIVE RISK TRANSFER SOLUTIONS OFFER SUBSTANTIAL ADVANTAGES TO FIRMS SEEKING TO MITIGATE THE IMPACT OF UNEXPECTED LOSSES ON THEIR FINANCIAL STATEMENTS AND UNCERTAINTY IN THEIR CASHFLOWS'

WHAT IS 'ART'?

'ART' describes a range of customised solutions provided by insurance or reinsurance companies that enable companies to finance or transfer certain risks in a non-traditional manner by utilising methodologies from both the insurance and capital markets. This may include the use of various forms of captives, finite risk insurance, loss portfolio transfers and integrated risk management programmes.

Equally useful are liability buyouts, which help mitigate volatility arising from past events. A buyout of a long-term risk, such as occupational disease or environmental liabilities, brings predictability to cash outlay and expenses. While liabilities can be forecasted, the risk exists that the forecast is inaccurate. A liability buyout mitigates this exposure and helps reduce spikes in losses.

STRUCTURED INSURANCE PROGRAMMES. Structured insurance programmes address unique risks that require an innovative approach, such as combining insurance and capital market techniques. These programmes usually contain a component of funding by the client, structured policy limits and the opportunity for the client to benefit from favourable loss experience. Most programmes will be highly customised to the particular needs of a client. Their aim is to protect clients from a wide variety of financial, strategic and operational risks for exposures that may be difficult to insure, particularly in the current market.

Structured insurance programmes offer a degree of year-to-year operational stability. The exposures these insurance solutions may encompass are broad and include:

- public liability, including products liability and employer's liability;
- financial lines, including professional indemnity;
- patent infringement;
- property;
- commodity-based volatility;
- trade credit and political risk;
- crisis management, such as product recall; and
- medical malpractice.

Structured insurance programmes help manage the emergence of a company's losses across a defined period, thereby protecting its balance sheet and cashflow from catastrophic events or from an unusual accumulation of severe losses. A well-structured programme will address the volatility of potential losses that affect the balance sheet and which may result in unexpected earnings fluctuations. In addition, it typically enables an organisation to lock in multi-year pricing to insulate against fluctuations in insurance and financial markets, thereby adding an element of year-to-year stability to financial planning and enhancing cashflow management. Ancillary benefits include the potential financial return of funds for favourable loss experience, evidence of coverage, when requested by customers or banks, as well as possible tax benefits.

LIABILITY BUYOUTS. Liability buyouts are another means of transferring risk through an alternative risk financing arrangement. They enable a company to manage volatility by providing certainty for existing liabilities. Liability buyout programmes are structured to help companies and their captives address corporate risk, balance sheet and income statement issues related to their loss provisions (for the corporate) or their loss reserves (for the captive).

As a rule, buyout programmes involve the assumption of liabilities that have developed over a substantial period of time through a contract of insurance or reinsurance. Ultimate losses and the payout pattern of those liabilities are actuarially determined and valued in present-day pounds. Premiums are based on expected losses and the total limit of liability in excess of expected losses desired by the client to protect it against adverse loss development. Buyouts can be customised to address virtually any liability, including, but not limited to, the following:

- public liability, including products liabilities;
- employer's liability, including occupational disease;
- environmental liabilities;
- merger and acquisition-related risks; and
- captive insurance companies loss reserves – known as loss portfolio transfers.

The benefits from an insurance buyout are many. First and foremost is the fact that the buyout will address volatility of accrued liabilities that affect the balance sheet, by transferring those risks to a third party – that is, the insurer. Eliminating this volatility often helps to eliminate operational obstacles to a company's growth strategies. The buyout also helps diminish the possibility that worsening losses will be a drain on future profits. It also helps release security supporting existing insurance arrangements and accelerates the tax deduction of liabilities through payment of insurance premiums. Finally, a buyout helps the company manage its cashflows by adding predictability to losses.

OPTING FOR PREDICTABILITY. Predictability is the key. Whether through a structured insurance programme or through a liability buyout, alternative risk transfer solutions offer substantial advantages to firms seeking to mitigate the impact of unexpected losses on their financial statements and uncertainty in their cashflows. By paying a predictable premium for insurance, a company can avoid an unpredictable loss – and the fact remains, it is always easier and more accurate to predict scheduled premiums than unforeseen catastrophes.

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