THE INFLUENCE OF CAPTIVES ON TECHNICAL RISKS INSURANCE

Technical Risks are many things at once. This means that the Technical Risks insurer is a strange animal who must be an engineer and salesman, accountant and lawyer, loss adjuster, underwriter and reinsurer all at the same time.

Primarily concerned with the insurance of production machinery and the financial consequences of breakdown but also covering the assembly of aircraft and satellites, the laying of sea-lines and the management and transport of machinery his field of operation is very wide. Giving all risks cover on electronic equipment and the construction of factories, fire and explosion cover on compressors and electrical equipment, he must have the knowledge of other insurers.

It is clear therefore that Technical Risks form an essential part of the commercial insurance market which in 1991, amounted to $ 170 billion worldwide.

Of this amount, the share held by traditional insurers is around 65 %. This means that 35 % is accounted for by alternative insurance markets i.e. almost $ 60 billion is lost to the classical market. Of this amount, one quarter relates to self-insurance which is progressing at the record rate of 10 % per year, whilst captive insurance or reinsurance companies take more than $ 10 billion in premiums.

There are around 3,000 captives in the world whose geographical distribution is, for well known reasons, very uneven : 1,780 in Central America, 540 in USA, 170 in Asia and the remainder, more than 500, in Europe. It is an activity, therefore, which is far from insignificant even if it concerns only a small part of the market. It is estimated that more than half of the "Fortune 500" companies have their own insurance or reinsurance company.

Their distribution, according to sector of activity is as follows : ahead the oil companies followed by shipping lines, metallurgical and chemical concerns, which are both very much involved with Technical Risks, follow closely behind.

I have just mentioned two types of captives, direct insurance and reinsurance ; we are most interested in the latter today as the former are under developed because of their delicate set up requirements and, more importantly, onerous administrative requirements.

Reinsurance captives which do not suffer these constraints have achieved strong growth. The countries where such growth is currently strongest are France, Germany and Scandinavia.

I do not think that it would be useful to dwell on history of which you are all aware. The development of captives has been assured by successive waves ; apart from financial advantages which I do not propose to list, captives also offer Risk Managers a large number of technical advantages.

- Self-insurance through deductibles allowed industrialists to come into contact with insurers. Captives have become the formal mechanism for direct contact with reinsurers.

- The captive allows the industrialist to continually increase his retentions whilst at the same time reducing his costs by a better knowledge of markets (experience rating, lower operating costs of reinsurers compared to insurers).

- A reinsurance captive is not subject to often very rigid insurance regulations.

- The captive, which appeared with Risk Management, necessitates improved risk analysis and control over the profitability of prevention and protection programmes. There is constant and necessary arbitration between the various components of the cost of risk : prevention, premiums and retained losses.

- The captive allows the industrialist to gain maximum credit for his deductibles which are then managed more coherently.

- Eventually the captive should be able to cover risks which the market either does not cover or only partially covers.

The captive is, therefore, a useful tool even if it is not magic and even if it is not necessarily adapted to all situations. The use of a captive as we have seen, is at the heart of a Risk Manager's function which seeks to organise a risk retention policy by re-grouping all the subsidiary companies of an industrial group and then to transfer the excess which he cannot or does not wish to retain over and above the "pain threshold" which he has himself determined. The captive feasibility study must fix this threshold, i.e. the optimum level of risk to retain ; in order to do this the loss record over at least five years, the MPL amounts and, of course, the financial standing of the company must be analysed.

The statistical study shows three distinct areas ; pure frequency, severity and pure hazard.

In the areas of pure frequency are repetitive losses which should be treated by way of deductibles because they are linked to maintenance problems.

The second area, that of large losses, known as pure intensity, is to be avoided. For the industrialist to assume this range of potentially large losses, very significant reserves would need to be constituted. The worldwide mutualisation of this type of risk as practised by insurers and reinsurers is undoubtedly less onerous than the financing of a captive.

The low frequency risks remain. When an industrialist develops a strictly controlled loss prevention programme into place, he can cede these known and controlled risks to his captive.

Moving from theory to practice is a delicate matter ; the creation of a captive presents essentially one danger and one drawback :

- The danger as I have said, lies in the choice of retention limits, especially during the first few years which are crucial because of the captive's lack of capital.

- The drawback lies in the cost of the captive which is not inconsiderable ; the cost of formation, administration and control. This has led to the creation of rent-a-captive facilities by insurers, reinsurers and brokers.

Technical Risks seem to have been only marginally concerned by the captive phenomenon if only because they do not seem to be, in the main, the type of risk which is too expensive to finance by means of insurance. More detailed analysis does show differences however between on the one hand Machinery Breakdown and Computer Covers and their consequential losses and Construction All Risks and their consequential losses on the other.

- The first category has, for better or for worse, undergone significant expansion through All Risks policies, either by the combination of existing policies or by the extension of Fire and Perils policies.

This has led to their being found to a greater or lesser extent in many captive programmes. We can only deplore that insurers and reinsurers have uncritically lent capacity to captives without having taken the trouble to individualise the branches involved.

This process, although relatively unimportant when only an accessory to Fire cover does have an effect when activities like the chemical industry are concerned, where breakdown is a heavy risk, especially its resulting financial consequences.

The fact that Technical Risks cover has not remained an optional extension treated specifically has prejudiced the Insurer's position.

The result of this approach is that premiums have been shown to be insufficient, technical warranties, whether relating to prevention or repair have been left aside and sums insured have often been aligned with those higher amounts relating to fire. Premiums and claims have only rarely been affected to the correct branch.

These phenomena have often been identified by the IMIA, most recently and with great skill by Mr Kethers. Nevertheless it is difficult to gauge precisely the premium volume thus diverted from Technical Risks insurers ; it is certainly significant.

What is more serious is that we have no reason to suppose that in years to come captives will not continue to take an increasing proportion of these covers. I can only exhort insurers and reinsurers to be more professional in the future, even though I do not see the lost Technical Risks premiums returning.

Captive development has therefore reduced the Technical Risks insurance market. We have not yet reached the stage of having insurance without insurers but we must be prepared for this situation to come about under the combined pressure of Risk Managers and the major brokers.

On the other hand, an important by-product of the captive is positive as far as the insurer is concerned, namely the development of a risk management awareness amongst managers of subsidiary company and profit centres. They are often ready to put effective methods of control into place in order to reduce costs. Co-operation thus develops between industrialists and insurers. It could almost be said that servicing, especially in technical insurance, is almost more important than cover which, for the industrialist, is relegated to second place..... useful in the event of a catastrophe.

It is by way of service and co-operation implicit between the parties that the insurer will remain at the heart of technical evolution and be in a position to contribute to it. Such is the situation in Construction and engineering. This co-operation is even more evident in the area of Technological Risks ; the role of the insurer is not to judge the decisions taken by the industrialist but to evaluate the risks when the latter decides to construct a product which presents a certain new characteristic, the 200 mw gas turbines for example.

As technological progress can result in transforming what would once have been a simple accident into a catastrophe, so the management of loss prevention and transfer becomes crucially important. Protection engineers and accountants who calculate the frequency and handling of events are equally involved. It becomes possible to state that the insurer then becomes the banker of pure hazard.

If the second category of Technical Risks is examined, i.e. EAR and CAR, captives have not played a significant role. There are several possible explanations for this :

- the extended duration of such covers generally require capital to be tied up over the long term

- in the majority of cases the joint-venture nature of many projects is an obstacle to the participation of captives. Similarly, when the insurance is effected in the name of the prime contractor, neither his captive nor those of the other contractors are asked to participate in the risk.

The case by case mounting of reinsurance arrangements, low rates obtained and the need for local policy issue are frequently cited by Risk Managers as obstacles.

As a result, very few captives to date have participated in such risks and have done so very tentatively.

To the best of my knowledge in France, only two captives are involved in EAR ; one a large electrical equipment manufacturer and one connected with the nuclear industry. Abroad, I am informed that some captives are active, especially in Sweden and Spain.

I have managed to find only one example of a captive involvement in CAR and only on one site. The future will not witness the widespread utilisation of captives in this area although it would not be unreasonable to anticipate some measure of relative development :

- in the area of CAR, large constructors or principals could be tempted to use captives as a method of promoting competition between their various divisions by rewarding claim free units with premium credit

- in the field of EAR, the major equipment producers may use a captive to ease the blow of insurers' refusal to cover risks arising from extended warranty periods, new materials and prototypes.

The effect of these covers is such that manufacturers will be obliged to include the cost of the risk into pricing and this element will need to be capitalised. Herein perhaps lies the way for insurers, after large deductibles, to participate in these long term covers.

As a general rule it is clear that the range of risks covered by captives will continue to be enhanced ; it is no less clear that captives will continue to bring certain advantages to the insurance market. Besides the fact that they will continue to provide capacity to direct operations they will serve as a link between insurers and industrialists who are already running speculative and uninsurable risks whose effects often largely exceed the extent of their insurable ones.

Captives also allow direct insurers to reduce the phenomenon of the good risks paying for the bad, to the general satisfaction of industrialists who deplore mutualisation.

The captives syndrome should, finally, contribute to improved underwriting results as the system relies, as we have seen, on the twin pillars of risk control and prevention

- from this language of prevention, insurers and insureds should develop a better mutual understanding. This is no doubt why certain insurers, far from showing hostility, have integrated captives into their development strategy creating rent-a-captive schemes for example.

- claims costs should reduce due to the insureds' participation in the risk. The tendency to inflate claims will disappear. I know a Risk Manager who criticised

the loss estimates provided by an insurer and who did not doubt that his factory managers' appetites were the reason for them.

The instigation of emergency planning greatly reduces losses.

All is not negative therefore in the world of captives and we have not seen a hiving off of whole slices of Technical Risks premiums to the disadvantage of insurers.

The direct insurer remains essential even if only as a front. In most cases he will also retain a share of the risk before ceding to the captive who in turn will retain a share of the risk before retroceding the balance to the reinsurance market.

In fact, this new competition exerted by captives is most keenly felt in the area of high frequency and low severity or else in areas of risk where insurers do not operate.

When we look at how greatly insurers value frequently removing deductibles and how reinsurance is increasingly concentrated on severity risks we are in a better position to understand how the development of captives has not seriously endangered our overall market.

On the other hand the captive has greatly reduced the need for coinsurance and therefore transfers a part of a national market's insurable interest away from the national market on to the more international reinsurance market. This allows reinsurance subsidiaries of direct insurers to recover some of the business.

We do not yet see therefore the institution of insurance called into question ; it is vital however that this institution reviews its costs, finds new markets and develops new ways of securing its role of managing the mutualisation of Technical Risks.

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