Relief is at hand

Directors tired of being over an insurance barrel now have some new tactics to tackle risk management.

Prue Moodie

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Successive steep annual premium increases leave no doubt that the world generally, including Australia and the Asia-Pacific, has been in a hardening commercial insurance market for the last few years. How long it will remain so is unclear. Greg Duncan, vice president of Australian operations at commercial property insurer FM Global, thinks the hard market will continue until at least the end of 2022.

"Insurance markets typically start to soften and prices start to decrease when insurance companies have been profitable for a period of time and start to reduce their prices to increase market share," he says. "In Australia, this has not yet happened."

What we do know is that the insurance market is reliably cyclical. Before 2017, the global commercial insurance market was soft for about five years, with small or no premium increases. So, if your company has been enduring unpalatable insurance costs and experiencing unsatisfactory claims outcomes, one of your choices is simply to bide your time.

Premium price rises are already smaller than when they hit a peak in September 2020, according to insurance broker Marsh's third-quarter 2021 global insurance report. One standout against the trend towards gentler increases was cyber insurance. According to the Marsh report, in the quarter to September 2021, cyber premiums in the Pacific area increased dramatically, in line with the global trend.

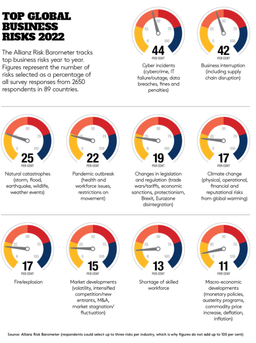
Taking control

Captives are one method that large companies use to escape premium purgatory. And according to Marsh, Australian companies have taken the option up in droves. Marsh sheets home the cause to dramatically rising premiums and unavailability of some insurance. Captives are fully owned subsidiaries that provide insurance coverage to their (non-insurance) parent company. If the company maintains discipline by providing adequate premiums to its subsidiary and keeping its risks down, there is a good chance that surplus capital can eventually be returned to the company.

Of course the opposite can also occur. If the captive is undercapitalised, "you may get volatility in your P&L and balance sheet," says Charlie Pollack, CEO of insurance mutual manager Picnic Labs. Or, if your captive uses reinsurance, your reinsurance premiums may increase.

The problem with captives — that is, apart from the risk that there won't be enough capital to cover liabilities in the startup phase — is the high overhead costs. Any financial rewards in the form of surplus returns are probably far in the future.

Pollack suggests that a company needs a premium bill of at least $2.5m before setting up a captive. Jessica Schade, head of captive and alternative risk transfer for insurance broker Lockton, says she doesn't judge the viability of a captive based on a set premium value, but looks at the organisation's strategic plan for risk management.



Capturing the advantages

The main lure of captives is the potential to get directly rewarded for reducing the likelihood of misadventure. The reward may come through returns of surplus capital to the parent company or lower premiums. There's little point in setting up a captive unless the company conducts a professional analysis of critical infrastructure and supply chain vulnerability — and implements resilience measures. Another advantage is that, with its inside knowledge of risk management systems, the captive may write customised coverage for otherwise unobtainable insurance.

Rehana Box, partner and co-global head of insurance at law firm Ashurst, notes reinsurers may view the captive as meaning the insured retains more risk. "That may make the reinsurer more comfortable in underwriting," she says.

Reinsurance is not compulsory for a captive, but it's advisable, particularly at the start. However, Box doesn't think that today's circumstances are ideal for setting up a captive. "It is preferable to set up a captive when the insurance market is soft and premiums for reinsurance low, so that the captive can build up its reserves," she says.

The cheaper option

There's a cheaper, cut-down version of a captive, called a protected cell. This is a single unit in an umbrella corporate entity — which can transact its own insurance business.

"Cells are quicker to establish, have less compliance/regulatory requirements and have shared operational services," says Schade. "But in this part of the world, there are not many domiciles with protected cell legislation that are in close proximity."

Singapore, which is the most popular domicile for Australian captives, does not recognise protected cells.

D&O in a captive

Whether captives can cover directors and officers (D&O) insurance remains a live issue, with some brokers suggesting that protected cells, in particular, may be able to offer Side A insurance.

Ashurst's Box notes that both group company — that is, stand-alone — captives and protected cell captives can offer D&O Sides B and C insurance.

"That's because Sides B and C insure the company or companies, not the directors and officers," she says. "But a captive company cannot fully insure Side A claims. Use of a protected cell captive to insure Side A claims may fall foul of the same statutory limitations if the funds used to pay claims come from the company group — directly or indirectly — or reinsurance paid for by the company group."

Captives are usually set up in low tax jurisdictions in order to gain tax advantages as well as insurance cost benefits. Premiums are deductible in Australia and taxed at a lower rate offshore. Although captives per se are not seen as undesirable by Australian regulators, says Box, "companies should note the risk that captives which do not reinsure may be considered transfer pricing under OECD rules".

Two final points to remember when setting up a captive. One, it's important to consider how excess capital will be returned in a tax-effective manner. Two, consider your exit strategy. What considerations will make a captive easier to unwind if you decide it's not for you? Box says it's usually administratively easier to exit a protected cell captive as compared to a captive subsidiary. On the other hand, a company has less overall control of a protected cell.

Discretionary mutual funds

Another option is emerging for those who feel abandoned or ill-treated by insurance companies: discretionary mutual funds. These work best for companies in the same sector. In the December 2021 report ***The Show Must Go On*** from the Australian Small Business and Family Enterprise Ombudsman, discretionary mutual funds were proposed as a possible solution for Australia's leisure and recreation sector. That is because activities such as carnival/theme park amusement rides and jumping castles have become prohibitively expensive to insure.

Anthony Taylor, policy and research adviser for the Business Council of Co-ops & Mutuals (BCCM), explains that a discretionary mutual fund (DMF) provides a product where the member — when a claim event arises — has the right for that claim to be considered by the mutual.

"That's as opposed to an insurance contract, where there is a right for a claim to be paid if covered," he says.

Because the payment is discretionary, many are wary of DMFs. But there are established examples, such as the Sydney-based CivicRisk Mutual, which provides coverage to local councils, and Xenia, which supplies coverage to the hospitality industry.

Melina Morrison, CEO of BCCM, notes that DMFs are part of both the state and federal governments' evolving policy response to hardening insurance markets, and typically arise where a market is failing.

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