

Steady route

In an increasingly soft market cell captives for specialty lines and programmes offer companies to two benefits of profit as well as stability argues, **Christopher L Kramer**

In the 1950s an Ohio insurance agent, Fred Reiss, needed to solve a problem for his commercial insurance clients who were facing property insurance rate rises despite much of the insurance market was in the middle of a soft pricing cycle. Valuing stability over the vagaries of the insurance cycle, his solution was the creation of a single parent captive – an insurer designed to insure the risk of its non-insurance owner.

Successfully retaining his client and the income to his firm, Reiss repeatedly used this model as a stepping stone to the creation of additional captives and more income, and in the process created such a competitive edge that was very difficult to compete against.

Aid differentiation

Today, captives make up part of an US\$80bn alternative risk transfer market and specifically cell captives – are not only being used by commercial insurance buyers, but increasingly by insurance agents, brokers and specialty lines programme administrators, as part of their strategic adjustments to differentiate themselves in an increasingly competitive pricing environment. In some cases, programme managers could see an additional 25% – 40% in revenue which could be used for additional ancillary services or profit-sharing with programme clientele.

While the property-casualty industry may reap as much as \$60bn in profits from 2006 – the greatest in the past 20 years – as a result continued disciplined underwriting and a relatively catastrophic-free hurricane season, these profits will add to the insurance industry's capacity to take on future natural or man-made catastrophes. In the meantime, the

accumulation of capital on the balance sheets of insurers will also undoubtedly speed the decline of commercial lines pricing in 2007, perhaps more than the 10% – 20% predicted in most commercial insurance lines.

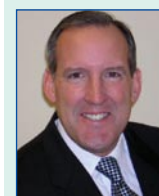
While the insurance industry has always been cyclical in its pricing, it causes havoc on insurance agencies and other insurance intermediaries bottom line. To help stabilise its firm's revenue stream many agencies or brokers have differentiated themselves by specialising in certain markets or services, such as risk management. Success often meant the firm could charge a higher premium than its competitors despite a soft market as the buyer would value the benefits they were receiving from the specialty lines producer.

However, today's insurance agencies and specialty lines managers face significantly different pressures to preserve or increase revenue than ever. These include the phasing out or redesign of incentive and/or profit sharing agreements by insurance carriers, the rapid discounting of premium to gain market share offered by new carriers – including captives and RRGs – or carriers simply exiting the market. Thus, the appeal of employing some sort of defensive competitive advantage to preserve revenue can lead to further specialisation or cost containment.

Specialty lines

The success of employing a specialty programme strategy has resulted in the specialty lines market has grown to a \$20bn – \$40bn market segment, according to a Guy Carpenter survey on the specialty lines market last year. The survey's other findings were that the use of non-admitted paper and alternative risk mechanisms were increasingly being used.

 **Briefing**
 **Cell captives**



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Another significant finding was only 15% of the carriers surveyed required the use of their own in-house claims department, down from 25% in 2005.

Stabilise income

Meanwhile the convergence of a continuing soft market in contrast with a growing profitable specialty segment, there may be no better time for programme managers to consider using a cell captive strategy as profit center approach to stabilise income, enhance cross-selling efforts or to retain policyholders.

Indeed, because of the manager's expertise in their chosen niche or specialty, most already have risk management, claims and loss control services for their clients, resulting in larger profits for insurers, but not necessarily for the producers. Differentiation for the programme manager need not be simply a product or service, it can also be operational efficiency via risk sharing strategies under a captive cell format.

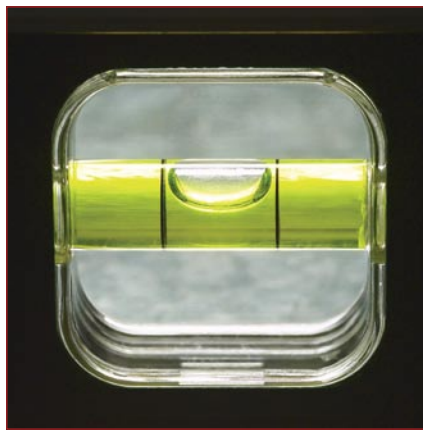
Using a captive for programme business is not new. The 1990s saw many specialty programmes underwritten in Bermuda by 'rent-a-captives', but a drawback was that each programme underwritten in the captive could be liable to the creditors of other programmes in the captive.

Today's advances in risk transfer technology and progressive legislation has seemingly addressed that potential exposure by passing 'protected cell' legislation which should enable each cell programme's assets and liabilities to be statutorily segregated from others in the captive.

Cell captives (also referred to as protected, segregated, portfolio or sponsored cells) are largely domiciled offshore, notably Bermuda, Cayman and Barbados, but certain US states have passed similar cell legislation, though most need to be 'sponsored' by an approved insurance carrier (Washington, DC is an exception). Their offshore counterparts require no such mandate.

Underwrite business

While the stability of a book or programme is vitally important to any agency or programme manager, some may consider using a cell captive to underwrite their business based on their successful track record in managing an existing book of specialty business having a high policyholder retention, the result of good client relationship management skills and service.



This usually results in low loss ratios (usually made up of low severity/high frequency losses) and a high profit margin for the insurance company, but not necessarily for the manager. By sharing in the risk with an insurer, however, the agency or manager can still produce income on the transaction but may also produce an underwriting profit and investment income as well.

Less capital needed

Underwriting specialty programme business under a cell format usually requires at least \$1.5m in premium, less if the cell programme does not require a policy to be issued by a front. Book Rollovers are ideal and usually preferred as starting from scratch takes much time and effort. Most cell captives will require a feasibility study or underwriting and loss analysis to determine the proper funding, retention and reinsurance required. Almost any line of insurance can be underwritten including casualty, property, workers compensation, as well as certain employee benefit plans.

A cell captive structure does not necessarily require the level of capital and human resources as is needed under an owned or group captive because the capital and surplus has already been provided by the captive's owners. At a minimum, the cell captive's owner or captive manager will provide all of the accounting, administration, compliance and captive management services required to supervise your programme, the costs of which may be included as part of a fee to use the cell captive, usually 2% – 5% of premium, perhaps more if the programme requires special attention or service.

Other costs and expenses to consider are fronting fees, reinsurance, collateral, claims expenses, taxes, auditing and any other services that are negotiated under the cell agreement, usually referred to as a 'participation agreement'. In some

cases, the captive's owners may provide capital or reinsurance support in exchange for a fee or participation in underwriting profits.

Besides the arduous task of finding an acceptable front, a major stumbling block to setting up a cell programme is often collateral. This is required by many captive owners as there may be some level of loss exposure that is not funded with cash yet the cell owners may be responsible to pay losses. Often referred to as 'the gap' it usually represents the difference between the cell loss fund (used to pay claims) and the attachment point of a stop loss reinsurance policy. Fronting carriers may provide a stop loss policy, but their attachments points vary widely, from 85% of the premium up to 125% or more.

While specialty programme managers, agencies or brokers most often hope to capitalise on their expertise by providing special coverage, sub-limits, or services to their clients under a cell captive strategy, there should be several caveats to consider. One is the separation of underwriting and production as one may be in conflict with the other. Often is the case where production goals may dilute underwriting discipline resulting in substantial losses or insolvency in return for short term profits, either from commission income or services provided. While brokers often know their clients better than the carriers that insure them, underwriting standards must be always followed.

Profit centres

Another dilemma is the issue of transparency. Should you as the manager or agency provide all details in your cell captive or risk taking position in the programme, will the profits be used to provide additional services for programme clients, profit sharing, or will it be easy to say you have 'skin in the game'?

Whether part of a smart client retention strategy, differentiation, or new sales plan, cell captives used as profit centers by insurance intermediaries may be one of the more formidable and strategic solutions an agent or programme manager may institute to solidify his firm's value proposition and preserve or enhance revenue steam, in a soft market or not.

The vagaries of the cycle will once again change and capacity will diminish, carriers will exit and policyholders will look for answers. The time to consider a cell as part of your plans is when the sun is shining and companies are looking for new business, not when it's raining, when umbrellas are in short supply.

