THE LATAM CAPTIVE

Adriana Scherzinger, of Zurich Latin America, highlights the importance of utilising a captive

Captives are one of the most efficient ways to control an organisation's risk management strategy. Outside of Latin America, captives are more readily accepted as a way of managing corporate risk and the number of captives in operation have grown worldwide. The main reason for this growth is that captives can help a company to reduce its total cost of risk and, increasingly, companies find that the financial and non-financial benefits of a captive programme can provide significant improvements right across its spectrum of risks.

This article provides an overview of the considerations and challenges when setting up a captive for Latin American companies. For existing captive owners, my hope is to demonstrate techniques for enhancing their performance.

Latin America captives

There has been increased activity in our region and it is no secret that the captive market has gained momentum with an average growth rate of just under 10% for the last four years. Insurance and risk professionals in Latin American are becoming more sophisticated and knowledgeable about captive solutions, and are increasingly looking to use these structures to plan their risk management programmes.

Adriana Scherzinger

Recently appointed as Zurich's head of international programme business in Latin America based in São Paulo, **Adriana Scherzinger** started the role in January 2019. Following stints at UBS and SwissRe, she has served as a (re)insurance specialist, a captive fronting manager and head of captive services for Latin America during her time with Zurich. Her specialities include captive feasibility, fronting and management. She studied economics at the universities of Rio de Janiero and Zurich.

Mexico and Colombia are the leaders. There is a growing interested in varied captive structures (single parent captives, protected cell captives) in these countries and they receive the most effort from the captive sector promoters. Argentina and Brazil are underdeveloped due to a current lack of knowledge. The captive concept, and the different types of captives, are not well understood and communicated. In addition, there are regulatory barriers which slow down the development of captives. However, I expect this to change over time as the acceptability of captives and knowledge about them grows.

Reasons for developing a captive

Captives are often used as an integral part of a company's international insurance programme. However, they can also cover local risks or be used in a purely domestic structure. The benefits for a Latin American company owning a captive are no different from companies in other parts of

the world. So what are the main reasons for utilising captive? There are four main reasons.

The first reason is to develop more control and freedom over risk management. A captive owner can design and price coverages to fit exposures with the aim of reducing the total cost of risk. The captive means risk professionals can create a formalised approach to self-insurance and funding of risks. Secondly, captives can help to control price volatility especially for uninsurable risks and risks which are difficult or too expensive to insure. The pooling of risks helps to motivate the group as a whole to improve its risk profile through long-term risk management strategies. This pooling has the result of building up reserves to increase risk-bearing capacity over time, especially for long-term risks, where internal self-funding is difficult.

The third aim is obviously to reduce cost, specifically in relation to premiums paid to the captive and through tax deductible loss reserves. Investment income is earned on premiums paid in to the captive and loss reserves. Cashflow improves as premiums are paid up-front and retained within the captive while claims are settled at a later stage. The combined affect is to reduce the costs of risk management. The final benefit is to gain access to the reinsurance markets which can offer broader coverages to the group and improve capability.

There has been an increase in demand from companies that are headquartered in Latin America. These multinationals are using captives as they expand their global footprint and utilise the structure to write cross-border risks. While the head office may be in Latin America, the domicile of the captive could be in the Caribbean, Europe and Asia. The location of the captive is driven by tax implications and the organisation's specific objectives and circumstances.

Historically, there has been a perception that it is only multinationals which have the required scale to manage and realise the benefits of a captive. However, this is not the case. In addition to multinationals, mid-market companies and companies whose exposure is limited to one or more countries are now successfully implementing captives and gain major benefits.

What types of companies have a captive?

There is no standard answer to this. However, there are certain characteristics which many organisations operating a captive share. There is a certain mindset in captive owners, they often have a willingness to increase their share in their risk and capture underwriting profits as opposed to simply buying insurance at the lowest price.

Companies with captives tend to have large enough premiums to warrant the annual cost of running this type of vehicle – typically premiums over €5m make it more feasible. But this should not be seen a hard measure. Companies with premiums lower than this can still realise significant benefits if their circumstances warrant it. For example, if a company has exposures to uninsurable risks or risks that are difficult or too expensive to insure, then a captive would certainly be an option to consider or a tendency towards higher frequency claims that have low severity.

Captives are not limited to any particular industry but those companies that do have captives tend to be medium to large corporations with business in multiple locations around the world. Generally speaking, these do tend to be multinationals aiming to consolidate risk exposures globally for a holistic view of risks and transparency of risk and cost returns.

If you are looking at employing a captive then a solid claims history, and extensive formal risk management processes in place, ensures you will have loss experience that is better than the market. This will enable you to benefit from a reduction in the cost of risk.

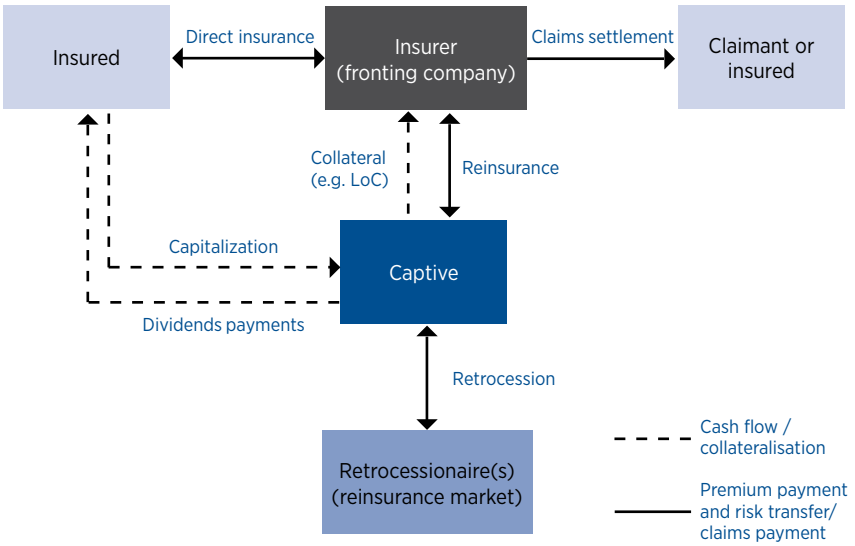
Generally, captives are used to write two types of insurance and there are synergies when combining non-life with employee benefits. The types of non-life solutions that can be added to a captive include property, casualty, motor, marine, specialty lines, construction, surety, trade credit and political risk.

The types of employee benefit that can be added to a captive are basic and supplemental life, long-term disability, non-qualified benefit, retiree medical, active medical, medical stop loss, workers' compensation, accidental death, business travel accident.

Creating a new captive

The starting point for creating a new captive should always be a feasibility study. A feasibility study will reveal information vital for maximising the benefit to an organisation and answering essential questions. For example, a study can be used to determine the optimal programme structure, risk retention, preferred domicile, services providers and detailed planning for the set up and licensing of a (re)insurance captive. Once it has been complete,

SINGLE-PARENT REINSURANCE CAPTIVE



Source: Zurich

an organisation will be in a strong position to define the type of captive which will best meet their circumstances.

Types of (re)insurance captives

There are three types of insurance, or re-insurance, captives that can be considered.

A captive can either provide reinsurance for a fronting insurer or write coverage directly to the insured. Under a fronted arrangement, a licensed insurer issues the policy directly to the parent/owner (insured) and then reinsures a portion of the risk to the captive. The majority of captives in Latin America are fronted, as regulations in many Latin America countries require a locally admitted carrier to issue the policies.

In a single parent reinsurance captive, a reinsurance company is formed to only reinsure the risk of a parent company and/or its affiliates which are not insurance companies.

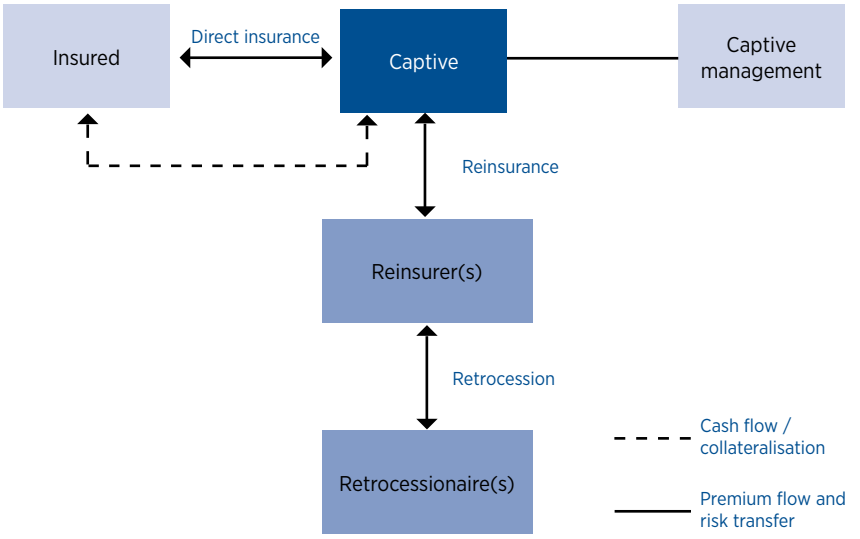
Insurance is provided by a fronting company which then reinsures the risks with the captive. If the captive wants to reinsure its risks it can do so through the retrocession. The retrocessionaire can be the same as the original insurer. The captive is responsible to only one party. The profits in single/parent captives are not shared and are earned by a single owner.

Unlike a single-parent reinsurance captive, a single parent direct insurance captive is subtly different (see diagram). In this situation, the captive provides the insurance directly and will need to hold the relevant licences. This method of implementation tends to be adopted by larger organisations with a more sophisticated approach to risk management.

There are now a range of newer solutions which can be utilised by medium- to smaller-sized businesses. In addition to wholly owned captives, there are also 'protected cells captives' (or a Segregate Cell Company) that allow companies to utilise a 'cell' within an existing captive facility.

A cell offers the many benefits of a captive without the full operating costs of a standalone captive (see diagram, page 9). This arrangement may be suitable for organisations that do not yet have the scale to set up their own captive but want to gain access to the benefits.

SINGLE-PARENT DIRECT INSURANCE CAPTIVE



Source: Zurich

Arbitrage and further developments in captive capability

Once a captive is operational and an optimised risk retention level has been determined, captive owners can use the vehicle to execute arbitrage strategies, which are particularly relevant in the current market environment. There are three types of arbitrage which can yield benefits to established vehicles:

> "When captives are well executed they can have a positive impact on an organisation's risk strategy"

Pricing arbitrage: A-rated insurance companies with large networks, for example, have expense ratios of a certain size. As reinsurance carriers are not required to finance a large network, they may have a different pricing approach from insurance carriers. Reinsurance carriers can therefore provide price offers for high excess layers that could provide financial benefits.

Capacity arbitrage: This was recently experienced in the banking industry, where organisations require large fronting limits with tailored wordings. The respective fronting insurers in the primary layer can have limited underwriting appetite. However, the insurance industry does have an underwriting appetite, more or less, for the excess layers. Comprehensive reinsurance panels behind a reinsurance captive could protect the gross captive exposure above a certain threshold. This generally requires a substantial captive risk retention and attention to counterparty credit risk matters.

Coverage arbitrage: A captive customer may want an insurance company to issue a tailor-made programme that meets their requirements or expectations, but exceeds the coverage the insurance company would provide. These policies could get proportionally reinsured up to 100%. Subsequently, the captive might have to accept wording exclusions to get reinsurers interested in such risks. For example, if insufficient data is available for specific risks, Monte Carlo simulations cannot currently be properly performed. In essence, the wording of the tailor-made insurance coverage would be much broader than that of the retrocession level behind the captive, with the captive covering any deviations.

Critical considerations

As you will no doubt be aware, there are many different factors to consider when launching a new captive or developing an existing vehicle. It would be impossible to cover all of the different considerations in detail here and we would always advise speaking to an expert to properly plan out a strategy. However, one area is becoming increasingly important.

Parent companies should be constantly reviewing the performance of their captives to make sure it is aligned with parent's corporate strategy. In addition, the parent should be keeping a close eye on regulation to make sure the governance of both the parent and the captive are operating with the right controls in place.

Increased regulation means there has never been more pressure on both the parent and the captive to have transparency and control. Central to achieving this is effective handling of data. Captives handle large amounts of data and need to provide reporting to the fronting carriers, reinsurers, regulators and brokers. Regulators are expecting captives to be run like commercial insurers and to ensure proper risk management policies are in place as well as fit and proper people in key positions such as risk management, finance and audit. This may sound alarming, but there are many solutions available which make this task simpler and take the anxiety out of the process.

Data management

When running a multinational insurance programme, risk managers need to analyse and make decisions based on large amounts of information. This can include navigating different jurisdictions, varying market practices and standards, and different regulatory environments. With so many different stakeholders involved, it takes great effort to administer a global programme and to keep it consistent.

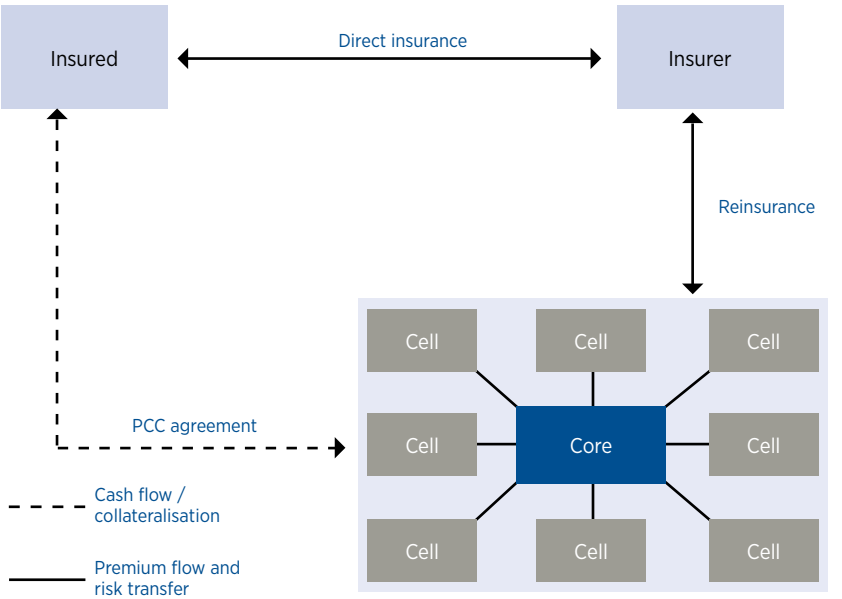
For this purpose, captive organisations usually have a Risk Management Information System (RMIS) in place to support their data management and control needs across the (re)insurance and loss prevention lifecycle. For any form of RMIS solution, it remains essential for the captive organisation to 'close the loop', get connected with the involved (re)insurers and establish an efficient data exchange mechanism.

In the past, the data transfer and administration involved usually happened by email with attached spreadsheets and documents. This led to inefficient and time-consuming data verifications and reconciliations, and in many places results in re-keying and inefficiency. Version control can be an issue and the risk of error is always increased when important information is transferred in this way. The way around this is for the captive to connect its RMIS solution directly to the insurer platform using an API (Application Programming Interface).

You've probably heard of an API (Application Programming Interface) through the era of 'open banking' but, if not, it enables different systems to talk to each other directly. APIs lay solid foundations for improving the speed, efficiency and consistency of data management and service delivery. Their use helps to reduce purely administrative, non-value adding manual work involved in transferring and reconciling data. The architecture creates an ultra-fast network between all of the stakeholders. Anyone who is set up can use API connectivity to integrate their risk management systems, enabling subscribers to access a number of significant benefits:

- Live data streams which cover all policy, claims and risk engineering information.
- Efficiency gains for the risk manager and his or her global team through elimination of manual data re-keying and reduction of data transformation errors.
- The latest status of any insurance data is instantly available in the customer system across the network.
- Increased standardisation improves consistency of data models between the insurer and the organisation's systems.
- An efficient and connected dataflow means users have time to focus on quality and improvements in service, so more time is spent on improving the performance of the risk management function. In addition, it enables the captive to better respond to increasing regulatory reporting and control pressures.

SEGREGATE CELL COMPANY



Source: Zurich

What happens next?

In terms of programme structure and design, a captive is one of the tools that can help a company reduce its total cost of risk. Their growth worldwide is testimony to the fact that when captives are well executed they can have a positive impact on an organisation's risk strategy. If you are considering utilising or enhancing your capability then you are among an ever growing group of risk professionals who have rightly identified captives as one of the vehicles that can improve the performance of their enterprise.