

# CHOOSING THE RIGHT PATH

Penny Hudson and Dennis McDonald of Caledonian Insurance Management Services Limited (Gibraltar) guide you through the self-insurance maze

SELF-INSURANCE, cell insurance, captive insurer, EU insurer, direct versus reinsurance – how do you know which route to take?

Self-insurance is an essential component of any business's risk-management strategy. Sometimes it is a result of a deliberate corporate decision; sometimes it is because insurance is not available (or not available at economic terms). Sometimes part of a risk is self-insured (by way of a policy excess or deductible) sometimes an entire peril (such as failure of creditors to pay) is retained.

The mix varies from business to business, but in every case prudent management will be aware of the risks involved, and seek to fund for the eventuality. However, an internal self-insurance fund is not an ideal situation. At the end of each financial year there will be pressure, both from within the business and from the taxman, to transfer any unused surplus in the fund to the profit and loss account – which makes it impossible to fund the risks over time which may result in a loss every two years or every 10 years.

Large corporations have solved this problem by establishing their own in-house 'captive' insurance company. There are now more than 5,000 of these around the world, and virtually every FTSE

100 company in the UK or Fortune 500 company in the US has one.

However, such companies require capital and are, therefore, not always appropriate for small to medium sized companies. On the flip side, they tend to be more the master of their own destiny.

Various solutions have been developed to enable these smaller companies to enjoy the same benefits from alternative risk financing as their larger competitors, but with mixed success. The protected cell is now emerging as the solution of choice to supply an efficient and effective method for dealing with this.

Similar considerations can apply to insurance companies themselves, where part or all of the bottom-end 'working layer' reinsurance requirements can effectively be dealt with in this way, with significant long-term advantages.

In an ideal world, conventional insurance or reinsurance is a perfectly good method of dealing with unexpected risk exposures, but it becomes less effective when the loss is expected, but the frequency is unknown. Cash swapping, where next year's premium is a factor of last year's claims, plus the insurer's costs and profit (and the broker's commission or fee) is never an ideal way

of funding risk exposures and, for the reasons mentioned above, self-insurance can be a poor alternative. Protected cells, and similar devices, are therefore emerging as attractive alternatives.

### Formalised self-insurance

Professional indemnity insurance for UK lawyers and accountants is a necessary evil that, from a cost point of view, has been particularly evil in former years. Even in current market conditions, where rates are becoming more affordable, this insurance still represents a significant financial outflow for the firm.

Over recent years, to keep costs to a minimum, many firms have increased their self-insured excesses on this insurance – often to a point where a single loss could have a serious impact on the profit and loss account for that year.

Prudent management will look to set aside funds for such an event, but internal self-insurance is not particularly effective over the long term, particularly where the taxman wants anything left in the pot at the end of the year to be treated as ‘profit’.

Purchasing a cell from a protected cell company (PCC) can provide a solution, as well as a vehicle for funding other self-insured risks, as the following example demonstrates.

### Case study

Professional Firm X (PFX) has a £250,000 each claim excess on its professional indemnity programme. It pays a premium of £360,000 to its cell. The cell has costs of £20,000 in respect of the annual administration fee. For a £40,000 premium, it purchases reinsurance excess of £200,000 any one loss £300,000 in all.

In the event of no claims, the cell has assets of £300,000 at the end of year one, which can be returned to the firm, or retained to allow the cell

to retain even more risk in the next year (possibly even risk such as bad debts or costs of defending uninsured legal actions).

The premium payable should be deductible, and there is no requirement to distribute any profit at the year-end.

This is just one simple example; there are many others, which include the EU route and the non-EU route. Obviously based in the EU, the cell can issue policies directly into the rest of Europe, ‘piggy-backing’ off the protected cell entity’s European passporting rights, but these are not usually rated entities.

With the non-EU route, such as Guernsey, the client may (depending on what risks he is writing) write directly into the UK, and may not need further European risk coverage. He may also use a rated or unrated ‘front’ for European risks and take a part in the reinsurance, thereby possibly simplifying the process, although the cost of the front will need to be considered.

Usually a sensible way forward for any company considering these options is a study covering all the relevant factors, such as long-term objectives, group requirements, premium levels, loss ratios, jurisdictions required, capital requirements (especially in light of potential EU Solvency II requirements and possible equivalence requirements in non-EU jurisdictions) and exit routes.

While it is usually true that in exploring the non-traditional there are always challenges and hurdles, it can also be true, for those who really know their business and their risks, in exploring with the correct advisers, it can also be extremely beneficial.

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