



Can a captive \$ave us from ourselves?

With a solid enterprise risk management strategy, a captive can increase in value and reputation, says Michael Zuckerman of Temple University

Is a captive insurance company: a money pit; an inconvenient chequebook needed simply to support a fronted self-insurance programme; or a risk management vehicle that can drive an insured/member strategic enterprise risk management (ERM) programme?

There is no doubt that captives can be expensive. They require capital and incur significant administrative costs. However, if a captive is simply a chequebook to support a fronted self-insurance programme, then maybe the parent should rethink the need for a captive.

Regardless of the captive's parent position, there is a significant research question that deserves the attention of both the academic and professional risk management community.

Can a properly managed captive insurance company be a driver of traditional and/or ERM maturity? Specifically, this research needs to address whether a captive managed according to generally accepted captive management best practices can be

used as a vehicle to promote and improve the insured/member ERM programme over the long term.

This article will focus on just one of many issues for which a captive can provide invaluable ERM support. Studies indicate that CFOs will talk about earnings shortfalls and accounting irregularities as risk issues that keep them up at night. Consequently, a possible credit rating downgrade is also a significant financial and strategic exposure, for most profit and many non-profit organisations.

A credit downgrade is a key risk indicator that the organisation is not effectively managing the operational, financial, and strategic risks that will eventually negatively impact its earnings before interest, tax depreciation and amortisation (EBITDA).

Moreover, a credit rating downgrade affects the cost of capital, increasing interest rates that may cause liquidity and budgetary instability. Ultimately, this could damage the organisation's

reputation. These are the type of issues that a well-thought out risk financing strategy, which includes the use of a captive, is intended to alleviate.

An organisation that self-insures an exposure to loss, such as professional liability or workers' compensation, must account for these losses as loss contingencies on its income statement (ASC 450). The organisation must, therefore, accrue for these expected losses for the fiscal period in question as a business expense, which is offset as a liability for retained loss reserves on its balance sheet.

Any manipulation of this accrual, such as understatement of expected losses caused by an overstatement of the discount rate, which cannot be supported by market conditions, or the use of a confidence level loss forecast that clearly does not recognise the variability in actuarial projections, puts the organisation at financial risk. Under-reserving claims is also a source of concern.

These aggregated issues may cause budgetary instability resulting in earnings volatility. In summary, corrupted loss data caused by systemic claims management issues, or manipulation of actuarial assumptions, could lead to an understatement of expected losses. This, in turn, may negatively affect EBITDA, creating a liquidity issue for the organisation when actual losses to be paid exceed expected losses. EBITDA volatility may result in a credit rating downgrade increasing the cost of capital, or at a minimum creating a major distraction for management caused by budgetary instability.

This is how financial exposure is better managed with a captive. A captive is a regulated legal subsidiary with its own board of directors. A director has a duty of care, loyalty, and candor. Specifically, this duty of care requires the director be informed about material captive operations including financial-and risk-related information to allow the director to be able to exercise the appropriate due diligence to make decisions and provide the required oversight of captive operations.

There are a series of regulators requiring transparency and knowledgeable oversight by the captive's board, including the broker/consultant, actuary, auditor, lawyer, captive manager, and even the captive domicile regulator. They all provide a layer of analysis, oversight and regulatory input that may not otherwise be available to guide the parent's risk financing strategy.

For example, a firm that is self-insured does not have to use an actuary to calculate expected losses. While the firm's external auditor and internal audit function are absolutely an important source of risk management oversight, they are not solely focused on risk financing issues with the same acuity that a captive regulator, actuary, auditor, broker consultant and management company would have.

Again, if the captive director is exercising their legal duty of care then they must be informed on the key operational, financial, and strategic issues facing the captive to be able to make reasonable and knowledgeable decisions in the best interest of the captive. In the spirit of Sarbanes Oxley, an act passed by US Congress in 2002 to protect investors from the possibility of fraudulent accounting activities by corporations, the director must be present at board, and relevant committee, meetings and given the appropriate risk management information to be able to ask questions and raise causes for concern about the captive's claims management programme (data source) and expected loss forecasts. These include key variables such as discount rates, confidence level variations, and actuarial methods.

This is an important aspect of captive due diligence required to assist the insured/member or parent in ensuring that its risk financing programme is meeting its goals of maintaining liquidity; to ensure ability to pay for losses; and to reduce the cost of risk and earnings volatility. The parent and captive risk management actions are interconnected and in this case, the captive's management process is driving the parent's due diligence, positively impacting the parent's risk financing goals. These risk financing goals are established to enable the parent to grow stakeholder value, and at the end of the day protect its reputation. In other words, enabling the success of ERM.

The captive's actuary, auditor, captive manager, broker/consultant, and attorney are the captive's human capital. The captive is also the product of an active and knowledgeable board, supported by this human capital that ultimately ensures that the captive is seeking and receiving an appropriate level of funding to pay its expenses and losses.

The captive board meeting, therefore, is an appropriate and efficacious conduit by which the directors are provided information about the appropriate steps taken to address risk data issues (audit of the claims reserving practices), expected loss variability, and the application of the appropriate financial variables and actuarial methodology needed to protect the parent's financial stability and reputation.

This is a first step in building a transformative captive insurance programme that positively impacts its parent's operations. Captives are expensive to operate. They require capital and an operational infrastructure to manage them properly. Most importantly, the captive requires the time and attention of the parent's senior officers, who sit on the captive's board, creating a critical risk communication pipeline. Without captive management best practices, it is less likely that the captive can contribute to its parent's long-term growth in value.

The captive's return on investment, therefore, should not be simply benchmarked against the parent's cost of capital. The parent must also consider the value of avoiding risk management and financing surprises that force the parent to seek funds to pay for unexpected losses that cause budgetary instability and adversely impact its EBITDA, drawing the interest of the rating agencies.

A credit rating review requires a complex process. Certainly, any threat to EBITDA warrants careful review. The captive can offer a progressive risk financing solution to address this issue, as well as other ERM issues, enabling the parent organisation to grow value over the long term and enhance its reputation. **CIT**



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