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Captives and the importance of being strategic

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What is the value of insurance to a company? More importantly for risk managers, what is the value of a captive insurer to the parent? Such questions should not be answered with reference to market inefficiencies or complexities, or talking about cheaper premiums, according to Reiner Hoffmann, Lead Consultant for Complex Accounts Underwriting, XL Group. Instead, the captive's strategic role in managing intangible or uninsurable risks should be emphasised.


Luxembourg

Speaking in a session at the European Captive Forum in Luxembourg, Hoffman compared captives with commercial insurers.

"The first point is that a captive has a stable client base. They have excellent access to the parent's risk. Captives can set up multiline portfolios. Insurers tend to be organised by line of business. A captive can assume individual corporate risks that allows for further diversification. And in addition, a captive can mix industrial lines with employee benefits," he said.

Diversification could also involve operational risks that are not traditionally insured. Mr Hoffmann talked about operational risks and how companies may face a risk that does not have an insurance product available, but, as he put it: "To apply insurance techniques would be a wonderful instrument to use for that operational risk."

The captive can provide this kind of innovation, acting as a strategic tool rather than just a financial or cost optimisation tool. As examples, he pointed to non-physical damage business interruption, supply continuity, cost overrun protection, liquidated damages, and contractual obligations. He explained that a captive could become the element that transforms a non-insurable operational risk into something that could be handled in the insurance market.

"I think captives can help their parents generate competitive advantage in their core business," said Mr Hoffmann. "This is the holy grail. Such captives become not cost-efficient vehicles but ones that support the core business of their parents. A captive should not be an expense optimiser, but more of a risk management tool."

As an example of this, he said there are captives that help to substitute price discounts with insurance offerings, or by covering a risk faced by customers - enhancing services by including seamless insurance products, or using insurance to finance the services.

He gave an interesting example of where a captive could be valuable from a strategic point of view. He pointed to a company that produces high tech energy-saving bulbs, designed to replace old inefficient bulbs. The company might want to back up its claims that the energy efficiency would mean lower energy costs by offering a reimbursement if this was not the case. A captive could provide the cover in the event that the bulbs do not perform as intended.

Mr Hoffmann explained that this is clearly a risk that could prevent companies from signing a contract with the bulb company, or perhaps discourage investors or banks looking to invest in the company. A captive could take that risk, so that the company could not only promise that its bulbs are energy sufficient and will create savings, but also guarantee it. The captive would in effect take the business risk, or the new business risk, he said.

He said there are no easy answers to the complexity of some of these issues - but he believed the market sometimes has a tendency to say that if there is no simple solution, it should stop talking about it, because it may not be able to deliver. "But if we stay reluctant and say that we know our property, liability, marine, but we don't want to get involved in the core risk management, then we may end up in the purchase department," he said.

There is no easy solution, said Mr Hoffmann. "The question is: is it worthwhile for the captive to be a partner in these kinds of conversations and find there is no simple solution, or the solution doesn't really help, or should we stay away from it, stay in our circle of competence which is, by definition, non-core for every captive owner," he said. And he added: "If you are in front of the CFO, and you cannot answer the question: what is the relevance of the captive for the corporate, then it doesn't matter what the market cycles do, what the reinsurance offerings are, or how the insurance market is changing. What is important is that you can answer that question from a strategic perspective."