

Alternative Risk Financing: Non-Traditional Options

Sparked by a wave of natural disasters and terrorist attacks, the costs of traditional insurance have risen significantly. Businesses are therefore now seeking alternative ways to cover their high-impact risks. **Rachel S. Kronowitz** and **Chidi J. Ogene** outline the benefits of a variety of alternative risk financing techniques.

Businesses typically purchase insurance policies to mitigate risk. In the past five to 10 years, however, businesses beset by higher premiums or by the inability of insurance companies to cover their risks adequately have sought other options. Increasingly, companies are finding that they can manage risk using financial instruments and other arrangements in addition to insurance policies. Known as alternative risk financing, these arrangements combine risk transfer and risk retention techniques with self-insurance to provide alternative (or complementary) options to traditional insurance.

Certain alternative risk financing techniques have been around for quite some time, and their popularity has followed or been affected by the vagaries of the insurance market. However, recent events have contributed to renewed, and quite possibly more permanent, interest in alternative risk financing. For example, catastrophes such as the September 11, 2001, terrorist attacks and natural disasters such as the 2005 tsunami and Hurricane Katrina (not to mention the impact of global warming and climate change) have led many to the belief that similar catastrophic events will occur with increasing frequency and that the hardening of property and casualty markets that occurred following these disasters threatens to be permanent.

In addition, recent corporate scandals led to the passage of the Sarbanes-Oxley Act of 2002, which requires chief executive officers and chief financial officers of publicly traded companies to certify that their companies have adequate internal controls. This statutory requirement has in turned convinced many companies of the value of a strategic, business-wide approach to risk management and has also led to the elimination of the traditional barriers between a company's treasury and insurance-buying operations.

These trends have prompted business executives to seek out other risk mitigation options, such as alternative risk financing. A September 2006 report by Conning Research & Consulting found that alternative market mechanisms now cover about 30% of the US commercial insurance

market, while traditional insurance companies cover the remaining 70%. In this article, we will examine a variety of different alternative risk financing techniques and products that companies now use to mitigate or transfer risk outside of the traditional insurance-based model.

Alternatives to Insurance Companies

Alternative risk financing products can be divided roughly into two principal categories: alternatives to insurance companies and alternatives to insurance products. In this section, we will identify different types of risk financing alternatives to insurance companies and we will explain their benefits.



Examples of alternatives to insurance companies include self-insurance, insurance pools, captive insurers and risk retention groups.

Self-insurance is one of the oldest alternatives to insurance companies and remains one of the most popular. The term is self-explanatory: rather than purchase an insurance policy, a company will elect to retain an eligible risk while designating an amount of money calculated to compensate for the potential future loss. Self-insurance typically provides the first layer of coverage, and a policy is purchased from the commercial insurance market to cover losses in excess of the self-insurance.

Following the 9/11 terrorist attacks, coverage for certain risks became much more difficult to acquire and was only available at substantially increased costs. For example, airline insurers immediately increased premiums and cut their coverage for third-party war and terrorism liabilities to a maximum of \$50 million per airline, per "event." Workers' compensation carriers began to look very carefully at catastrophic exposures, especially in locations with more than 250 employees. And some life insurance reinsurers exited the market entirely.

As a result of these developments, many companies have increased the amount of risk that they self-insure. For instance, coverage for catastrophic losses might be secured by designating a \$75 million-a-year self-insured retention and by combining this retention with traditional insurance; this strategy would provide coverage in excess of the retention amount at greatly reduced premiums.

Insurance pools, or self-insurance groups, are an extension of self-insurance and are employed by companies to underwrite their collective exposure to workers' compensation claims and similar high-occurrence, low-cost risks. These groups tend to be comprised of companies with similar risk profiles (either by type of industry or by geography or both), because each member of a pool shares the profits and losses of the pool through a so-called joint and several liability arrangement. Members contribute premiums to a fund, the proceeds of which are invested and paid out for claims and administrative expenses. Surplus funds may, at the members' discretion, be repaid by members or reinvested in the fund.

A November 2004 study of 16 self-insurance pools rated by A.M. Best found that the pools compared favorably to traditional insurance. The report found that self-insurance pools, compared to an index of commercial casualty insurers, had a five-year average investment yield of 4.9% versus 5.3% for the commercial casualty index, a five-year average return on equity of 12.2% versus 3.1% for the commercial casualty index and a five-year average underwriting expense ratio (i.e., the percentage of premiums used to pay underwriting expenses) of 23.6 versus 28.0 for the

commercial casualty index.

A *captive insurer* is, in general terms, a licensed insurance company established by a non-insurance parent company to insure the risks of the parent company, its affiliates or other entities doing business closely with the parent company. Captives are considered to have a number of advantages over traditional insurance coverage. Companies utilizing captives enjoy cash flow benefits from lower insurance costs and retention within the corporate group of premiums and investment income.

Captives can also provide tax benefits: for example, payments to captives that provide employee benefits insurance are deductible as insurance premiums in certain circumstances. Additionally, the company's control over the captive subsidiary allows it to deal with reinsurers directly, instead of through an insurance company, thereby lowering the cost of access to the reinsurance market.

Perhaps in response to these perceived benefits, the use of captives has grown tremendously in recent years.

Risk retention groups are similar to multi-owner captive insurance companies or self-insurance groups. They are liability insurance companies owned by their insureds (which must be engaged in a similar business or exposed to similar risks) and they are authorized by the Liability Risk Retention Act of 1986, which permits the insurance company — once licensed by its state of domicile — to insure members in all states.

These groups enjoy many of the benefits ascribed to captives — such as the ability of members to control their own program, the ability to maintain coverage at affordable rates where typical insurance is hard to obtain and the ability to access reinsurance markets directly — without the hassle of having to set up the corporate structure of a captive insurance company as a subsidiary.

According to the *Risk Retention Reporter*, risk retention group annual premiums increased from approximately \$2.2 billion in 2004 to \$2.4 billion in 2005; moreover, these premiums have almost doubled since 2002.

These groups now underwrite significant portions of the medical malpractice market, following the insolvencies between 2001 and 2003 of many of the traditional malpractice insurers. However, it is important to note that these groups cannot underwrite certain risks, such as an employer's liability with respect to its employees, or loss or damage resulting from any personal, familial or household responsibilities or activities.

Alternatives to Insurance Products

Credit securitizations, CAT bonds, weather derivatives and finite risk products are among the available alternatives to insurance products. Many of these instruments are products of the capital markets: a consensus is emerging that the

global capital markets have capacity exceeding that of the insurance markets by several degrees of magnitude and, consequently, can handle at a lower cost and with less shock to the system the occurrence of natural disasters and other severe risks. In this section, we will explain the benefits of different types of risk financing alternatives to insurance products.

Credit securitization involves the transfer of assets subject to credit risk, such as receivables, to a specially created investment vehicle. The vehicle in turn issues securities “backed” by the transferred assets. The proceeds of the sale of the asset-backed securities are remitted to the transferer of the assets — the entity that otherwise would have purchased insurance to defray its credit risk — and the purchasers of the securities assume the risk of recovery of the assets.

CAT bonds, more formally known as catastrophe bonds, are risk-linked securities designed to transfer a specified set of risks from the issuer to the investors. They are usually structured as corporate bonds whose repayment of principal is forgiven if certain specified trigger conditions are met. These conditions are generally linked to some sort of catastrophic event, such as a hurricane hitting Florida. If no hurricane hits, the investors enjoy a return on their investment through interest payments (typically at a coupon rate much higher than the risk-free rate) and the principal repayment over the life of the bond. But if the triggering event occurs, then the investors may lose their rights to some portion of the principal or the entire principal, which is retained by the issuer to pay the loss. As the hurricane example suggests, CAT bonds are most frequently used where the risk sought to be defrayed is a high-severity, low-frequency event.

Weather derivatives are financial instruments that can be used by companies as part of a risk management strategy to reduce the risk associated with adverse or unexpected weather conditions. The derivative in this case is some objective measure of the weather, such that the weather derivative pays based on the variability of the observed weather from an index. So, for example, a weather derivative might pay based on the number of days when a low (or high) temperature was exceeded. Farmers, for instance, would use weather derivatives to hedge against poor harvests that result from a lack of rain or unseasonable snowstorms. Theme parks, on the other hand, might use weather derivatives to insure against rainy weekends during peak season. Energy companies, in particular, have been at the forefront of the development of the weather derivative market.

Finite risk products are similar to traditional insurance,

but with a twist. Unlike typical insurance contracts, which typically have a duration of 12 months, finite risk insurance products have a longer term — say, 10 years. These products are particularly useful where the risk sought to be insured against is a high-severity, low-frequency event, such as an oil spill. For example, if we assume an actuarial analysis predicts the occurrence of an oil spill within the next 10 years, the probability of such an event occurring in any one year within that period is 1 in 10 (or 10%).

The oil producer could, of course, insure that risk by purchasing an annual insurance policy. If the risk did not occur in that first year, the oil producer would be out its premium, which the insurance company would have invested to produce income for its shareholders. The oil producer would then need to renew the insurance policy for the following year. If the risk also did not materialize in that second year, the result would be the same as the first, and this would continue for each year the annual policy is renewed and the oil spill did not occur.


Alternatively, the oil producer could procure at the outset a finite risk contract that covers the entire 10-year period. If the oil producer and its insurer estimated that the oil spill would occur in year seven, they could reduce to present value the resulting liability. In exchange for the payment of a premium approximating that liability estimate, the oil producer and its insurer would agree to share the investment income generated by the premium. The oil producer also would be entitled to deduct the premium paid at the outset of the transaction and — if the insured risk did not materialize during the term of the contract — to the return of a substantial portion of the premium paid.

These benefits have made finite risk products increasingly popular, despite the negative press attention these products have received as a result of alleged abuse by certain insurers and reinsurers.

Final Thoughts

In this article, we have outlined a variety of risk financing alternatives to traditional insurance companies and insurance products. However, the list of alternatives we have covered is not exhaustive. Moreover, as the insurance and capital markets continue to converge, we expect different and more exotic alternative risk financing products to materialize.

As our discussion illustrates, alternative risk financing is not one-size-fits-all. Determining which option, or combination of options, works best for a particular company requires a thorough analysis of a company’s sources of, and attitude toward, risk. ■

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