

Incubating risk

The lack of knowledge about emerging risks can worry corporate risk managers. However, 'incubating' that risk within a captive can start to develop a track record for the risk, which can then be introduced into the commercial market once data is available

by **Nick Smith, senior risk management consultant, Charles Taylor Risk Consultants**

A scan of recent events shows that organisations are increasingly exposed to economic consequences of events over which they have no direct control and against which the normal complement of risk management tools and techniques have limited impact.

Take volcanic ash as an example. Airports in Northern Europe are well aware that another eruption of Eyjafjökull, the unpronounceable Icelandic volcano, could put them out of business for days or even weeks. Having knowledge of the risk is one thing, but buying business interruption insurance to cover the exposure is

quite another. And the economic impact of this risk was not just limited to airport operators. Organisations involved in the logistics sector, particularly those involved in the transportation of perishable goods, were exposed to significant economic loss arising from circumstances where they had no control and limited rights of redress. Insurance markets do not yet fully understand the economic consequences of risk to organisations from volcanic eruptions and are unwilling at present to cover their exposure to ash-induced closure.

With volcanic ash, while there is undoubtedly an insurable risk, there is simply too little information available

for insurers to quantify and price the risk. Other emerging risks face the same problem; take for example insurance to protect against breach of patent and other intellectual property. It is relatively easy to buy cover to protect a company against losses directly related to the breach of intellectual property; but cover which extends to cover the legal costs of fighting an intellectual property case is very thin on the ground. It is known for example, that a major global chemical business, which was acquired during consolidation of the sector, insured patent infringement and pandemic risks within its captive insurance company.

Nurturing risk

Insurers, understandably, are generally only comfortable about accepting risks where there is a track record of losses. This enables their exposure to be modelled and a sufficiently accurate price for the risk assessed. Then the normal dynamics of competition and supply and demand allow a working market for the risk to emerge.

The lack of knowledge about a new risk and the lack of a claims history is a real dilemma for corporate risk managers. On the one hand they know they have an insurable risk which may lead to a claim. On the other they cannot insure the risk because no one has paid a claim on that risk before.

In these circumstances, clearly, one option for the corporate risk manager is to, metaphorically, shrug their shoulders, make their corporation aware of the exposure and expose its balance sheet to the economic consequences should such an eventuality occur.

For those corporate risk managers who have a captive at their disposal, there is another, perhaps less volatile, solution to this dilemma. The captive can be used to act as an 'incubator' of

however, can be highly beneficial to all parties. The corporate protects itself against a new and emerging risk, and reinsurers can gain knowledge of a potentially profitable new line of business.

The first step is risk identification. When a new risk is identified in a company's risk register which cannot be readily insured in traditional commercial markets, there needs to be agreement that the risk can be retained by a captive controlled by the company. More often than not, this is not simply a decision that the corporation can take in isolation. The reinsurer of the captive will have to be aware that the new risk has been attached, and accept that any retention established in the captive to meet this risk has the potential to erode their deductible and also impact capital requirements.

For example, a claim against the captive controlled by an airport operator for closure due to volcanic ash could easily exhaust the primary layer of cover, leaving the reinsurer immediately exposed to any other 'traditional' losses. This will clearly impact risk pricing and may well limit the reinsurance markets available to the captive.

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new and emerging risks. By placing an emerging risk into a company's wholly owned captive, or into a cell of a segregated cell captive, the risk 'owner' can start to develop a track record for the risk which can then be introduced into the commercial market once sufficient data is available.

While the theory is straightforward, the process requires careful management, and all parties to the incubation process need to be involved and in agreement at all stages. This includes the corporate risk manager, the captive management company, reinsurer of the captive and brokers. The outcome,

Alternatively, where it is difficult to obtain reinsurer's agreement to include this new and emerging risk, the full financial consequence of the risk or, at least, up to an agreed amount can be retained entirely within the captive without affecting the reinsurance programme. In these circumstances, a fund is at least being built up which may soften the impact of the financial consequence of the risk if and when it occurs.

While it has always been difficult to get cover for emerging risks, it is arguable that the current soft market has helped the development of captives as risk incubators. When rates are soft,

reinsurers are more likely to consider allowing the captive retention to be eroded by the attachment of new risks. In a hard market, when reinsurers can achieve better rates for traditional, known risks, the appetite for allowing a relatively unknown exposure to erode their deductible is likely to be less.

Planning ahead

Once the risk has been accepted by the captive, it will be possible to build up a track record of claims over a number of years. By carefully assessing historical loss data and reviewing loss experience in the captive, a better understanding of the emerging risk can be assessed. In turn this data can be used to introduce the risk to commercial markets. Here education and involvement of brokers and commercial insurers will be an important part of the process.

There is little doubt that some types of risk are more suitable to captive incubation than others. On the whole, these will be emerging risks that can be covered within relatively modest limits. For example, it is unlikely that a corporate would be able to insure their exposure to their defined benefit pension scheme deficit in a captive and expect reinsurers to accept the erosion of their deductible. Here the pension liabilities are difficult to calculate accurately and can vary enormously as a result of changing legislation, longevity and stock market movements and the reinsurer's risk exposure could be considerable.

Other risks are more suitable for incubation. In addition to volcanic ash and patent infringements, emerging cyber risks have the attributes that make them suitable for retention by a captive, while the commercial market develops an understanding of the extent of the likely liability. There is some cover available for cyber risks, but it is presently relatively limited.

A captive would be entirely suitable to insure losses such as non-material damage business interruption; for example, when a hacker shuts down a company's order processing system and sales are lost.

Commercial insurance markets are understandably reluctant to accept new risks about which they have no knowledge or understanding. By using captives to accept these emerging risks, risk managers and their advisers can provide immediate protection against losses and engage on a longer term process of incubating the risk for future acceptance by commercial insurers. ☺