

## Armco's concept of the insurance captive

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Article abstract

Dans notre revue nous avons fait paraître une étude sur la compagnie captive, sous la signature de monsieur Mayes, le président-directeur général de l'AFIA. Aujourd'hui, nous présentons aux lecteurs un cas particulier, celui de la Belfonte Insurance Company fondée pour accueillir les affaires du puissant groupe américain Armco. Par la force des choses, la société a évolué pour sortir de son cadre initial et elle est devenue une véritable compagnie d'assurance où jouent la loi des grands nombres et la règle de la répartition des risques. Son président-directeur général, M. Robert Lee, présente ici l'évolution de la société et les étapes qu'elle a parcourues.

# Armco's concept of the insurance captive

by

R.C. LEE

*Dans notre revue nous avons fait paraître une étude sur la compagnie captive, sous la signature de monsieur Mayes, le président-directeur général de l'AFIA. Aujourd'hui, nous présentons aux lecteurs un cas particulier, celui de la Belfonte Insurance Company fondée pour accueillir les affaires du puissant groupe américain Armco. Par la force des choses, la société a évolué pour sortir de son cadre initial et elle est devenue une véritable compagnie d'assurance où jouent la loi des grands nombres et la règle de la répartition des risques. Son président-directeur général, M. Robert Lee, présente ici l'évolution de la société et les étapes qu'elle a parcourues.*

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There have always been good reasons why some have found it necessary to go beyond the frontiers of conventional insurance practice. By its very nature and also by the requirements of regulation — described by one as 19th Century controls for a 20th Century machine — the insurance industry is often diagnosed as suffering from a hardening of the attitudes.

History — The U.S. insurance industry is almost 200 years old now — discloses that insurers were many times unenthusiastic about a certain kind of risk to be insured; a certain kind of cause of loss to be covered or even a certain kind of insurance technique to be introduced. As a result many industries, areas, activities or individuals did not have any protection at all or it was felt that the protection provided was inadequate.

It is worth recalling that many insurers were first organized because of a need that was not met by the then conventional market.

The Millers Insurance Company was formed in 1865 under a special charter to provide insurance protection on the uninsurable grain elevators. State Farm and Allstate were organized to try out new marketing techniques. The creation of the reciprocals in the United

States and the protection and indemnity clubs abroad was essentially to redress the intensity of feeling prevailing at that time against certain insurers.

Professor Greene in his recent book refers to a humorous but also interesting exchange of correspondence between a housewife in the Middle West and an insurance executive in the East that so often characterizes the attitude of the insurance industry.

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Dear Madam.

In reply to your letter esteemed favour of the 23rd instance, we beg to say that windstorms being entirely foreign to the business of fire insurance in which we are engaged, we have nothing to do thereof. Neither do we suppose that any other respectable fire company does, but only such companies that must resort to some ludicrous method or worse in order to get any business. One would hardly expect to find ready made horseshoes for sale in a millinery store yet such a commodity would have as fitting a place in such a stock as windstorms would have in the business of fire insurance.

The introduction of the concept of excess and surplus lines is largely the result of the failure of the prevailing industry to come to grips with the deductible and other special requirements of the insured.

The success of many of these experiments suggest that the outcome could have probably been quite different had the insurance industry not had a one eyed view of the (then) insurance scene.

It is also worth considering that more recently, the emergence and growing prominence of the captive insurance company is not an abandonment of hallowed insurance tradition but a continuation of a discernible pattern of developing a new approach when the current method is found wanting. This pattern is almost as old as the United States and is made possible under the umbrella of our competitive system. In other words, the considerations that influence the formation of today's captive are essentially the same as those which lead to the formation of the companies mentioned earlier.

Added to which are newer and perhaps more sophisticated reasons. To illustrate with a few examples from many:

A pure captive which covers only the exposures of its parent may be organized to obtain insurance cost reduction. In 1970, for example, « Tidewater Marine Services U.S.A., incorporated Pentac Co. Ltd. in Bermuda, to insure its fleet of vessels. The essential reason was the failure of insurers to reduce premium costs when Tidewater was willing to assume higher deductibles.

A pure captive may also be formed to obtain broader coverage, or to write a type of cover that was unobtainable at that time. The American Newspaper Publishers Association representing some 400 newspaper publishers across the United States set up the Mutual Insurance Company Ltd. to write strike insurance as well as libel and slander for its members.

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Johnson and Johnson in the drug field, formed the Middlesex to provide liability coverage on one of its uninsurable products (birth control pills).

In the same vein the association or industry captive — which writes the insurance of members of a given industry — is formed to provide cover currently unavailable at any price or on mutually acceptable lines. Verlan Limited owned by the National Paint and Lacquer Association, and the Oil Insurance Co., owned by some oil companies, are two illustrations.

There is also perhaps a lesson to be learnt by the abortion of the Airline Insurance Company. I think that although there were capital difficulties the main reason for the abortion was the willingness of the insurance market to provide the needed capacity on competitive terms, thus eliminating the need to create a new insurance captive.

Other reasons that are often cited in this context are:

1. Emphasis on risk management, and formalizing self-insurance.
2. Reducing administrative expenses.
3. Integration of foreign and domestic insurance programs.
4. Possible tax advantages.

Here at Armco with our Bellefonte Insurance Company, our line of development almost mirrors that of most of what has happened in the past, and by way of a brief background let me sketch for you the main milestones in our growth and the reasoning behind it.

Armco first formed a captive insurance company in 1953. This is the Bellefonte Insurance Company, which was formed to write Armco's property insurance. The program was quite successful and continued basically without change until October 1968. At that time, we were forced to change the program by reason of our inability to find sufficient capacity in London for the reinsurance during a period of limited capacity in most of the national and international markets.

108 The cover was then placed with the FIA on all properties in the United States with a deductible which continued to be insured in the Bellefonte. Coverage on Armco's foreign properties was continued in the Bellefonte with the reinsurance placed in London.

To this point of time the Bellefonte was a pure captive. But as a consequence of this change in events we studied the situation to determine whether a captive company had a future in our risk management program and, if so, what we should do, if anything, to make it more effective.

It was our conclusion that it had an important future and it would be more effective in meeting requirements if the premium base was substantially expanded by the addition of non-Armco insurance business. In 1969, on the basis of a very detailed report, Armco management approved our recommendation and authorized an additional investment of \$15 million to the approximate \$1.8 million then invested to enable us to implement our recommendations. Of this sum, \$10 million was invested in the Bellefonte, and \$5 million was used to form a new company in Bermuda. This is the Bellefonte International which was formed in 1969, and began operating on January 1, 1970.

The decision to convert from a pure captive to a "senior" or "broad" captive, selling insurance and reinsurance services to others as well as its parent was due to several factors based on our analysis of our prior experience with the Bellefonte.

On the positive side we found that:

1. Because our captive afforded virtually first dollar cover, we had accumulated very detailed statistics concerning our losses over a span of 15 years. This had enabled us to take corrective action in several significant areas of exposure before serious losses occurred and to develop a sophisticated approach to engineering for loss prevention.

2. The captive was an excellent means to spread costs associated with property exposures throughout our entire Armco operation, without abandoning the principle that costs should bear a relationship relative to exposure while also protecting against losses that could seriously impact a single profit center.
3. Through the medium of a captive we had been able to obtain an insurance cover that was specifically tailored to our type of business and the exposures associated with it.
4. A broader coverage for Armco had been obtained at less cost and we had made a profit in addition.

On the negative side, we found that:

1. As a pure captive, we were dependent on reinsurance to cover "impact losses". By this I mean that a captive within itself is not able to absorb a loss any larger than one that the parent company can afford to absorb without impacting its profit in any one year.
2. The market for reinsurance by a captive is not nearly as large as it is for a publicly operating insurance company, particularly during times when capacity is limited.
3. There are often difficult legal problems in insuring non-U. S. operations in a captive because regulations in many countries require the insurance to be placed with a licensed company in order to expense the premiums. In other cases, there are stiff penalties for failure to insure locally.

Because it was obvious that the captive had been important to our risk management program, and could be more substantially utilized to enlarge its value, we concentrated our attention on the question of what could be done to eliminate or minimize the negative aspects of such an operation.

On the first one, it appeared to us that a logical alternative was to exchange our non-manageable "impact" exposures for exposures that we could manage. Basically, this meant exposures that had sufficient credibility in terms of "per risk" exposure and frequency to be insurable within the confines of our net retention. In the most elementary sense, it appeared that if we could develop a plan that would enable us to assume a broad spread of manageable non-Armco insurance business

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sufficient in premium income to offset our outgoing cash flow and to offset the long term profit associated with our outgoing insurance placements, we would successfully solve this first problem.

On the second problem, we felt that if we became involved in the insurance business as a broader based risk taker, we would over a period of time find a more receptive market for our reinsurance requirements.

110 On the third problem, we likewise felt that by becoming involved in the insurance business, we would open up new doors for placing locally qualified insurance, with reinsurance into our captive of our account or other business.

As we explored this concept of exchanging a portion of our risks for risks of others, we found that it was not only a solution to the most serious problems we had found in operating our captive, but could be further developed into a viable profit center for Armco.

We have made substantial progress in this direction. Now in the fourth year of our operation, we have a significant worldwide insurance business, specializing in all forms of reinsurance and in direct excess and surplus lines. In terms of premium income, we expect to book in excess of \$50 million in this year, with another \$20 million in the pipeline which is about what our original objective was for the year 1975. Last year our net income after tax was just over \$3 million and our objective this year is \$5 million.

In other important areas, we have been able to put together a strong group of carefully chosen insurance and investment specialists that in addition to enabling us to operate an insurance business, lend depth and experience to our corporate risk managers. This strengthens our risk management program while also providing additional career opportunities for our employees in Armco's insurance business.

Our reinsurance arrangements also have become much stronger, giving us flexibility in planning our reinsurance requirements. There is then a return to Armco as a whole larger than just the dollar return on the project itself.

I am confident that we have only begun to see some of the advantages of this type of approach. In the years ahead as products liability exposures become even more difficult, as new technology continues to

create new uncertainty, the need for new and imaginative insurance covers will continue. I feel that in the search for new solutions to our problems, we at Armco will have, as a result of our entry into the insurance business, the talent to develop the solutions, and a receptive insurance market to place the required covers.

From a commercial point of view, I feel insurance buyers will continue to call for new ideas. Although pure and senior captives are symbolically on the periphery of the insurance industry our involvement in providing new ideas can continue to change both the method and the performance of the industry with resulting gains to all.

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**Voici la conclusion d'une grande maison de New-York<sup>1</sup> à propos de ce que sera le marché des assurances aux États-Unis, en 1974:**

« In the commercial lines currently, much less is heard of the sharp rate cutting and aggressive bidding for business that occurred in 1972 and earlier last year. Those of the larger companies that may have been aggressive bidders have curtailed such activity dramatically. While overall margins still appear to be satisfactory for most larger risks, indications of the shrinkage in 1973 appear to have had a meritorious effect. Competition from smaller companies for some of the larger risks apparently has abated. There remains some rate competition for regional and smaller risks, but this can be expected to moderate in time. Trends in workman's compensation are mixed, but more companies are showing some improving trend as rates appear to be catching up somewhat with the increased benefits of the past several years. The troublesome general liability lines still are causing difficulties, particularly in the professional segment of the market, and reserve strengthening appears to be continuing.

1974 will not be a good year. In the personal lines, auto underwriting margins may deteriorate further. The April tornadoes have started the homeowners line toward the 100% combined ratio mark. Another major storm and it will roll into the red. Commercial property insurance will show the effects of the tornadoes, as well as the rating practices of 1972 and of 1973. Commercial casualty business still suffers from the poor professional, medical and product liability experience of the past few years. Investment income will be up, but what does that matter if the bottom line is virtually unchanged? »

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<sup>1</sup> Blyth, Eastman Dillon & Co. Mai 1974.