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Résumé de l'article

La conception d'un programme d'assurance multinational suppose un savoir-faire, une planification stratégique et une connaissance approfondie des lois applicables dans les pays où l'on opère. Les défis du gestionnaire de risque dans une société multinationale passent par une vision globale et une compréhension à long terme des risques, de leur contrôle et de leur financement. Cet article jette un peu de lumière sur ces aspects et il envisage certaines solutions concrètes et pragmatiques.

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A Broker's Perspective: Managing Permutations of International Risks[1]

by

Peter T. Clark[2]

La conception d'un programme d'assurance multinational suppose un savoir-faire, une planification stratégique et une connaissance approfondie des lois applicables dans les pays où l'on

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opère. Les défis du gestionnaire de risque dans une société multinationale passent par une vision globale et une compréhension à long terme des risques, de leur contrôle et de leur financement. Cet article jette un peu de lumière sur ces aspects et il envisage certaines solutions concrètes et pragmatiques.

This report develops the concept that the design of a multinational global corporate insurance program requires proper planning and understanding of local laws and customs. Taking a long-term, global view of corporate risk management objectives with proper evaluation and implementation of the risk finance and risk control mechanisms sets the foundation to transfer risk economically, and guarantees that funds will be available to pay losses when they occur. Understanding how to use before tax dollars to fund for losses and transfer risk is an intricate process involving local admitted coverages and reinsurance. This report attempts to shed some light on this process, and it makes some suggestions on how to minimize the effects losses may have on corporate income taxes as well as ways to manage global risks that will stand the test of time.

Permutations in the International Insurance Scene

On the international scene, brokers face numerous permutations of the structure of an international insurance program. Permutations imply a rearrangement of constituent elements that effects change and creates new form with essentially the same material. And so it is with international exposures. It is not that the risks are any different from those in the United States, but that the treatment of these risks can significantly affect corporate earnings per share and raise havoc with foreign operations.

Probably the most abused and misunderstood part of a multinational risk management program is the overseas portion. Lulled by the misconception that either the corporate umbrella's protection or the foreign subsidiary's insurance program will take care of potential loss problems abroad, some U.S. corporations have moved into international markets without seriously thinking about the effects of an overseas loss.

What usually happens in this situation is a classic case of Murphy's law: if things can go wrong, they will. For example, a major French fire loss as a result of windstorm is not covered because the French policy does not cover "fire following a windstorm." Fire following a peril is covered only if the peril, itself, is covered. Even if it were covered, if the insured value of the destroyed property were less than 100 percent, underwriters would only respond on a pro rata basis.

Local autonomy of overseas operations can "hoist a multinational by its own petard" when a major catastrophe occurs and a local insurance policy wording does not cover the loss. Then, too, relying on the corporate umbrella to pay a foreign loss in a country that disallows "non-admitted" insurance can have serious legal and tax ramifications.

Safeguarding corporate assets overseas may require deviating from established corporate standards. Being forewarned is being forearmed. Every corporation wants to avoid surprises, and to do this, many multinational corporations have developed an international risk management strategy that is a complex and sometimes frustrating exercise. Evaluating a design to prevent, avoid, reduce, and even assume the effects of losses takes on a new meaning when dealing with overseas operations. What heretofore was a "laissez-faire" attitude toward foreign risk management techniques is rapidly becoming part of a global strategy; developing this kind of strategy takes teamwork and good communications from the chief financial officer, corporate risk management, the international broker, and the multinational underwriter. This team makes sense out of conflicting laws, language disparities and incompatible insurance and business customs. Their ability to rapidly communicate information works to avoid mistakes, enhance mutual awareness, and to some degree increase understanding of the way business is done abroad.

The Global Risk Management Strategy

There are three essential elements to a global risk management strategy: a corporate risk management function; a top management mandate that resources will be committed to allow for recovery and operating efficiency after fortuitous loss; and a policy that the risk management function and objectives apply internationally as well as domestically. The key implication is centralized risk management

planning and control that will identify exposures to loss, analyze the best techniques to protect exposures, select the proper risk finance vehicle to handle losses when they occur, implement a risk management program worldwide, and then monitor it.

This exercise is a complex task and takes planning, patience, persistence, and persuasion along with the assistance of an international insurance broker to accomplish global risk management goals. What is available in America is available internationally, and next to a centralized risk management program, planning is most important.

The planning goals would include:

- common expiration dates,
- a coverage standard,
- cost effective premiums,
- uniform expense factors,
- local claims service, and
- local loss prevention service.

Accomplishing these goals is not easy and can take up to three years of persistent work involving standardization, consolidation, and centralization of control. The reason: local management recalcitrance, policy cancellation provisions, and communication difficulty make this a time-consuming process.

Bear in mind that overseas subsidiaries may be territorial and protective of their own insurance program, so diplomacy and support from top management are needed to overcome their resistance to change.

Standardization *(First Year).* Probably the most important feature of a multinational insurance program is the broker selection. It is the broker's expertise and network that aid and abet consolidation of local programs that are consistent with the planning stage goals. As an insurance advisor to clients, a good insurance broker organizes his or her people to represent an extension of a corporation's risk management process by:

- identifying and evaluating risks abroad,

- developing and negotiating insurance contracts at the local level if necessary,
- providing assistance and leadership in the control and reduction of risk hazards, and providing expert assistance in loss settlements.

In general, the standardization phase develops uniform standard protection of exposure abroad through a program of locally placed insurance within the framework of a master contract controlled at corporate headquarters.

Consolidation *(Second and Third Year).* To maximize economies of scale by continued consolidation and refinement of the overseas program, all lines of international insurance should be included. Local management recalcitrance will need to be overcome by continued internal pressure and lobbying to gain acceptance of a corporate risk management philosophy. All of the services and systems established in the standardization phase need to be reinforced and refined during this phase.

Centralization & Control *(Third Year).* By now, the final phase of a maturing global risk management strategy is now in place and functioning. The entire plan is under the risk management department's and the broker's control. Continued research and refinement of risk management services and reporting procedures is extended to remaining subsidiary and affiliated companies. The risk manager and broker systematically plan for the protection against loss by requiring local subsidiaries to perform risk identification, risk measurement, risk treatment, and plan implementation through computerization of a risk management information system (RMIS). The information developed in this process is used to develop a conceptual plan that includes a global retention plus a risk finance vehicle. The goal is to implement the retention as cost effectively as possible with the proper risk transfer excess of the retention.

Before a plan design can be drawn for a global risk management strategy, however, there are several things to consider, all of which have a bearing on the risk finance vehicle chosen to carry out the strategy; they include legality of coverage implemented, corporate risk management philosophy, local management, premium expense and its tax deductibility, taxation on loss settlements, and gaps and duplications in coverages. Because the risk finance vehicle is so important in the global risk management strategy's implementation, the insurance broker should be considered a key figure in this process.

The Broker's Profile

The broker is the cornerstone of a multinational risk management program. It is the broker and the broker's network that make the global risk management strategy work through quick, efficient communication and service. Because control is a key issue in managing international risk, it is important to carefully evaluate and establish an international brokerage network. Some international brokers have "hands-on" control over the quality of service their network performs, while others must rely upon a "correspondent" relationship which at best is relatively inefficient in the execution and service of insureds' needs. It is imperative that the risk manager take an active role in interviewing and evaluating each overseas brokerage office that will service the corporation's account. Just as the risk manager picks a domestic broker to provide vital services at home, the same scrutiny should prevail abroad. The overseas brokerage network performs the same important functions as the domestic broker does, and their accountability should be to the client, not to the parent company's brokers office. Because of the need for control and the need to be proactive rather than reactive to events abroad, the risk manager should establish a "network" of qualified overseas brokers who are knowledgeable and flexible, and who provide the required services in the countries in which the corporation operates. The major multinational brokers provide excellent "networks" of qualified personnel at home and abroad to service their client's needs; however, insureds have little say over the quality of service in some instances and in many respects must purchase "the broker's product" instead of designing their own. Some brokers have "networks," but this does not mean the risk manager has to rely on them. Many large insureds tailor their own foreign brokerage networks accountable to them through their domestic broker or through a European consortium of brokers.

It is the need for qualified assistance about the "unknown" abroad and local representation that creates the need for an overseas brokerage network. The broker's global support as an extension of corporate risk management opens opportunities for clients by:

- developing a larger brokerage presence locally and gaining market share by expanding potential underwriting capacity through reinsurance facilities in London, New York, and Europe;
- providing timely intelligence about local risks and social problems;

- providing innovative coverages for target risks either during construction or during the completion and operational phases;
- providing expertise to integrate corporate programs with the local country's coverage requirements;
- advising proper funding levels of pension and benefit programs;
- providing full local brokerage claims services for physical loss or damage to assets or earnings, fraudulent or criminal acts, death or disability to employees, and legal liability arising out of civil wrongs; and
- providing proper translation of program descriptions to enhance local understanding and acceptance.

Most global brokerage networks maintain local service quality by expanding risk management knowledge and techniques through technology transfer (risk management techniques and reinsurance capacity). This is done by seconding an expatriate whose knowledge and experience are shared with the local nationals. Additionally, indigenous support is rendered by senior expatriates from key regions where assistance is a few hours away.

The lifeblood of any multinational insurance program is communication. It is the response to problems and the ability to communicate effectively that make the program work. Knowing how to communicate and motivate local nationals is a nuance at which most multinational brokers are expert. They enhance these qualities by holding regional seminars in Europe, Asia, Australia, or Africa, where the free exchange of ideas and techniques is discussed in an attempt to assimilate the common standards in each country. This ongoing process of program uniformity and standardization is reinforced by a "policy digest system" in which complete, accurate, and up-to-date information about events and policies in force is capsulized in digest form. The policy digest is a prerequisite for an effective international insurance program, and it is updated annually as a kind of stewardship report for corporate risk management.

Fundamental to coordinating and communicating information about a global risk management program is the broker's international representative or account executive. This individual is responsible for providing the conduit through which the client communicates with the services they have purchased abroad. This conduit enables the

insured to bind a closer association with the overseas subsidiaries and improve the uniform administration required to meet the challenge of structuring and refining an international risk management program.

Overseas Risk Finance Vehicle

Basically, coverage abroad comes in three forms regardless of the major sources of loss: admitted, non-admitted, and a combination of both. These approaches apply to property and liability coverages used to transfer risk abroad. How they are used and implemented can have a significant effect on the cost of risk transfer as well as on the amount received by the insured when a loss is paid. To better understand the ramifications of this statement consider the data in Table I.

Local Admitted Insurance (*coverage purchased indigenously for local terms and conditions and paid for in local currency*). The advantages of this type of coverage are *tax deductible premiums* because coverage complies with local laws and *locally paid claims* in local currency per policy "terms and conditions."

The disadvantages are high premiums due to local rating tariffs, restricted named peril coverage, and lack of coverage uniformity and control due to dissimilar policy wordings and inexperienced management buying the coverage.

Non-Admitted Insurance (*coverage purchased in the United States from a multinational underwriter outside the foreign country for American terms and conditions and paid for in U.S. dollars*). Here the advantages are coverage, cost, and currency. U.S. policies are cheaper and broader, and losses are payable in U.S. dollars. Coverage is purchased through a U.S. multinational underwriter, London, or a combination thereof for uniform terms and conditions, deductibles, and limits. All decisions about overseas insurance coverages are made at the home office, and losses if any are paid for at home in U.S. dollars.

Losses when paid under non-admitted policies in most cases are considered income by the Internal Revenue Service and taxed accordingly (IRS Ruling, Rev. Rul. 56-636). This can have a deleterious effect on expected recovery and can create financial

problems at the local country level if non-admitted insurance is disallowed. For example, if the corporation's tax rate is 46 percent and it sustains a loss in an admitted insurance country like Italy under a non-admitted cover, the loss payment in the U.S. is subject to tax as income to the corporation at the corporate tax rate. The Italian profits will be offset by the uncollected loss locally, while the after tax recovery in the U.S. will be 54 percent of the loss. The net loss to the corporation would be the after tax payment plus the net loss in Italy.

Now, the corporation may wish to effect repairs and rebuild the destroyed Italian asset. The new influx of capital to rebuild the asset will be taxed by the Italians at about 12 percent, not to mention the potential exchange restrictions applicable to the new capital coming in to Italy.

Every country's insurance legislation is different and some countries require that certain coverage, such as automobile insurance, be carried locally. Noncompliance with these laws is subject to fines and what is more, premiums paid to non-admitted insurers are not a legitimate tax deductible expense locally where non-admitted insurance is disallowed.

Combination Admitted and Non-Admitted Insurance as part of one program gives insureds the best of both worlds; namely, broad uniform coverage, alleviation of tax and currency control problems by virtue of local underlying policies, plus availability of local brokerage service. Premiums paid at the local level will be tax deductible as a legitimate business expense. Losses, if any, will be paid locally without being taxed as income to the corporations in the U.S. Non-admitted coverages, on the other hand, are prohibited in some countries and because of this, they will be paid for with after tax dollars, and losses might be taxed as income at the corporate tax rate as outlined above.

The master policy approach provides broad U.S. terms and conditions with difference-in-conditions coverage over local admitted underlying policies currently in force or over the broadest terms available locally. The master policy acts as reinsurance of local admitted policies and allows for expensing premium and paying for losses locally without any tax disadvantages non-admitted insurance is heir to.

Having a centralized risk management department and plan design is essential for the successful implementation of the international program. The system to implement and carry out the plan design contemplates control at home either through the broker (the A account) or through the underwriter (the B account) and their respective networks.

The *"A" account* refers to a method a multinational, parent corporation uses to control its foreign insurance program. In the "A" account both the *broker* and the underwriter use their combined "overseas networks" to underwrite this account, issue local foreign policies where required, bill and collect local foreign premiums, and service the indigenous engineering and claims needs of the insured client.

The *"B" account* on the other hand, is a method multinational underwriters use to provide "local" services for insureds who want to *avoid using a broker's "overseas network."* The global underwriter provides the parent corporation with a master policy and, where they are required, issues local admitted underlying policies to the subsidiaries through its local office. Because there is *no local brokerage involvement,* premiums, engineering, and claims service are handled by the global underwriter's local company.

Depending upon the ubiquitousness of the underwriter, the broker's foreign network, and the corporation's need for local services, the deciding factor for either the A account or B account approach is control and accounting discipline. Control and accounting discipline are required to monitor the issuance of local underlying policies, premium collection, and the flow of reinsurance funds. If foreign subsidiaries perform complicated functions involving manufacturing and processing with high values, there are some definite benefits to the A account, namely, superimposing the broker on the underwriter's execution of proper coverage, limits, and premium collection and remittance, not to mention the brokerage services available locally. On the other hand, if foreign subsidiaries are service contractors or are involved in warehousing and distribution functions without high concentration in values, the B account may be the most cost effective approach. The B account's main drawbacks are accounting for premiums, policy issuance, and lack of local brokerage services although the overall cost can be less than the A account.

Because control and accounting discipline are provided by the underwriter and its network under the B account, monitoring policy issuance, premium collection, and reinsurance premium cessions to a captive insurance company become the underwriter's responsibility. Their network is controlled by the U.S. "Home Foreign Office" and regional control offices abroad. It is the home foreign office that establishes the conduit through which the parent corporation's U.S. broker communicates abroad for his or her client rather than through the broker's network. By avoiding the indigenous broker, insureds save commission dollars but lose local brokerage services and to some degree control over the program's financial integrity if a captive insurance company is involved.

Captive Insurance Companies: Their Role in Funding Overseas Retentions

Because local admitted country tariffs do not allow enough credit for large retentions (excess of $5,000), getting premium credit for a $100,000 retention is accomplished through reinsurance. By utilizing the "A" account approach insuring risks abroad, multinational corporations can gain significant premium reserves for losses by establishing their own captive insurance company to act as a reinsurer of a global underwriter.

A captive insurance company is a wholly owned subsidiary of a noninsurer that wishes to insure its own risks. It is primarily a financial tool to contain costs, maintain consistent cash flows, as well as a risk management tool to reduce "risk cost" (the sum of premiums, self-insured losses, administrative expense, and loss prevention costs). The resulting benefits, in addition to enhancing financial leverage, are increased capacity to assume risk and direct access to the reinsurance market, that is, dealing wholesale rather than retail.

Establishing a captive insurance company presents a long-term commitment requiring substantial capital and management expertise. Because substantial funding is required to satisfy the country of captive domicile as well as the captive's reinsurers, a feasibility study should be prepared. The study should investigate the captive's use, management, tax, and accounting functions unless a corporation already has a captive. Even so, a feasibility study should be done to evaluate the risks assumed by the captive and the retention level for losses as well as the aggregate of losses the captive would assume

during the year. The study would also outline the benefits and drawbacks of various captive domiciles (Bermuda or Cayman Islands, for example), describe current tax aspects as they relate to the corporation's financial interests, and provide some investment alternatives for accumulated funds in the captive.

Since there are two possible reinsurance scenarios for a global reinsurance scheme, it would be worth considering how they work and the drawbacks of each.

The first consideration contemplates a mature, well managed captive insurance company, domiciled in a country where communications and banking services are sophisticated enough to move money quickly and where the captive's underwriting services are mature enough to provide proper reinsurance agreements for each country's policy that it reinsures. The program is known as the "Flow Through Model," where the captive reinsurance company literally acts as a reinsurance company of the local admitted insurance contracts, accounting for the flow of funds ceded to it and retroceding (reinsuring) excess of loss to the master contract arranged for by corporate headquarters.

Cash flow from premium reserves and investment income is the obvious benefit of the "Flow through Model." Collections of reinsurance premium from abroad, individually arranged reinsurance contracts per country, and the administrative burden of currency exchange and reinsurance commissions are the main disadvantages.

The other, more attractive model for handling foreign risks reinsured to the captive is the "Net Retention Model." Instead of the local admitted insurer reinsuring to the captive insurance company, the local insurer is reinsured by the master global contract for its pro rata share of the local risks. The global master than retrocedes (reinsures) the balance of risk to the captive up to the captive's retention. The benefit to the Net Retention Model is mainly administrative because the global master contract handles the accounting, the expenses (ceding commissions and overrides), and currency exchange with remittance to the captive in U.S. currency.

International Employee Benefit Group Pooling

Just as one multinational insurance carrier is used to consolidate and coordinate an international property and casualty insurance

program, a multinational benefits insurer does the same thing for overseas employee benefits by issuing a "master contract." Because most large multinational corporations self-insure their employee benefits abroad, insurers like Travelers, Aetna, Winterthur, and Swiss Life offer their "networks" to them to allow these corporations to gain financial control over expenses, improve coverage, simplify benefit programs for expatriates and third-country nationals, provide uniform underwriting standards, and improve communications with local subsidiaries.

Essentially, by "pooling" international benefits in a master contract, insureds can use the "network" of either one carrier or an amalgamation of affiliated carriers to issue local admitted benefits contracts to each subsidiary abroad. The local subsidiary has freedom to negotiate the coverage it desires to conform with local custom, local laws, and competition. Since the master contract is between the parent corporation and the international insurer, the experience of all countries is "pooled" on a participating profits basis, producing possible dividends, and in effect legally receiving credit for retaining risk thus reducing the cost of employee benefits abroad.

Since the concept seems simple enough, it is not without problems, with debits and credits becoming important considerations. Accounting for each country's cash income and outgo is generally broken down into credits, debits, retained funds, and balance or surplus. For example, if a global corporation has subsidiaries in Belgium, France, Germany, Italy, and Mexico, the pooling account might resemble the data given in Table II.

There are many nuances to rating multinational pooled benefit accounts, but two are worth mentioning. Since risk size is the most significant factor in the experience rating method, insurers use either a "stop loss system" or a "loss carry forward approach" to smooth the financial transition from year to year and make a charge accordingly in their "risk charge." In the stop loss system, a fixed risk transfer cost is added to guarantee the "supra dividend" when the aggregate of all claims equals or exceeds a certain level. The loss carry forward approach provides for debits from past years' bad experiences to be carried forward by establishing a contingent fund that is available prospectively to soften the effect of a bad year in the ensuing year. Sometimes an aggregate limit is placed on the carry forward amount, and insurers make an appropriate risk charge for this in their

calculations. Additionally, there are the "administrative charges" and "pure risk transfer charges" that are part of the fixed costs that remain as a constant in the dividend calculation. In essence, multinational employee benefit risk pooling is cost plus protection using the resources of a multinational underwriter to provide local admitted protection where required and returning the unused portion of the premium dollar not committed to fixed overhead expenses or to paying claims to the insured as a dividend.

Conclusion

Given the realities of international commerce, nationalism, currency controls, and balance of payments, the global risk management plan needs to be practical in its approach, flexible in its design, and adapted to local custom using locally arranged *legal* policies where possible. This overall approach is longer lasting and better able to solve problems efficiently when they occur and provide required local services without the legal and tax problems other approaches may bring. For the large multinational it may be best to consider a global master reinsurance contract reinsuring a captive insurance company whose main function is to act as an exchange/funding clearing-house for local admitted policies abroad. This centralized financial control reduces "frictional costs" (brokerage, ceding commissions, and overrides) and expands the availability of purchasing pure risk transfer at wholesale prices through the reinsurance market.

An added ingredient and one that cannot go unnoticed is the multinational broker. His or her expertise and knowledge of foreign customs and laws aids large multinational corporations in gaining and maintaining control over their global risk management program. It is the broker's international network that provides "hands on" stewardship and impetus to overseas underwriters policy issuance, premium cessions to the captive, and loss prevention service. They are an important catalyst in the communication of information and a conduit for the maintenance of financial integrity of the risk finance vehicle chosen to implement a global risk management strategy.

In a sense the permutations of international risk management consist of a rearrangement of financial components so that the premium expense to the subsidiary is the same but the remittance to underwriters for risk transfer is changed. The new form created consists of a corporate "global retention" by sharing risk with the

global underwriter through reinsurance. The vehicle to accomplish this can be the captive insurance company that allows the multinational corporation to accumulate overseas funds for losses and buy risk transfer wholesale rather than retail without sacrificing the benefits a multinational underwriter brings to the global program.

TABLE I

EXAMPLES OF NON-ADMITTED VS. ADMITTED LOSS

	Non-Admitted	Admitted
ITALY		
Profit after Tax	$100,000	$100,000
Loss (fire)	($500,000)	$500,000
Subsidiary Net after Tax (Loss) Gain	($400,000)	$600,000
U.S.		
Recover from Non-Admitted Insurance	$500,000	0
Tax (46%)	($230,000)	0
Net after Tax Recovery	$270,000	0
Net Loss to Parent	($130,000)	0
ITALY		
Recapitalization from Parent	$500,000	0
Tax 12%	($60,000)	0
Balance	$440,000	0
Fines (estimated)	($50,000)	0
Net Capitalization	$390,000	0

TABLE II

CALCULATION OF EMPLOYEE BENEFIT SURPLUS
AN ILLUSTRATION
(U.S. DOLLARS IN THOUSANDS)

		BELGIUM	FRANCE	GERMANY	ITALY	MEXICO	TOTAL
	Number of Lives	150	200	350	200	30	930
	Coverage	Death and Disability	Same	Same	Same plus Retirement Income	Same	
I.	**CREDITS**						
	Prior Year Reserves	0	0	0	0	0	0
	Premiums	167.5	54.3	141.0	563.5	10.1	936.4
	Interest	1.2	0.8	6.5	26.4	0	34.9
	Total	**168.7**	**55.1**	**147.5**	**589.9**	**10.1**	**971.3**
II.	**DEBITS**						
	Year End Reserves	0	0	20.2	103.5	0	123.7
	Expected Claims	155.1	38.8	70.4	281.8	5.0	551.1
	Commissions[1]	8.4	2.7	5.6	22.5	1.1	40.3
	Administration[2]	7.3	3.1	6.3	18.1	0.2	35.0
	Risk Charge[3]	0.6	3.3	5.9	1.2	0.2	11.0
	Local Dividend	0	1.1	28.2	112.7	0	142.0
III.	**Surplus (loss)**	**(2.7)**	**6.1**	**10.9**	**50.1**	**3.6**	**68.2**
IV.	**RETAINED FUNDS**	(Contingency Fund Potential for Loss Carry Forward)					
V.	**SURPLUS DIVIDEND**	(1.6%)	11.1%	7.4%	8.5%	35.6%	7.3%

[1] ***Commissions** — paid to local broker.*
[2] ***Administration** — local policy insurance charge.*
[3] ***Risk Charge** — varies depending on stop loss or risk carry forward.*