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Résumé de l'article

Finite insurance, une forme d'assurance non traditionnelle qui suscite beaucoup d'attention sur le marché alternatif de l'assurance et de la réassurance I.A.R.D., peut être la réponse aux problèmes que représentent les expositions volatiles ou les sinistres à liquidation lente, engendrés par la responsabilité civile produits, la responsabilité professionnelle, la responsabilité civile pollution ou d'autres risques trop coûteux à assurer ou trop difficiles à placer sur le marché. Occupant un segment de marché restreint, la *finite insurance* découle du principe qu'en contrôlant soigneusement l'exposition au risque, il est possible de souscrire des affaires rentables. Ainsi, en plaçant une limite sur l'exposition au risque, il est plus facile de prévoir ses résultats de souscription. Dans son article, Monsieur Hartman présente le concept de la finite insurance, un outil de financement de risque for intéressant pour certains gestionnaires de risques, ainsi que ses caractéristiques et son avenir sur le marché.

Finite Insurance*

by

Douglas H. Hartman**

Finite insurance, *une forme d'assurance non traditionnelle qui suscite beaucoup d'attention sur le marché alternatif de l'assurance et de la réassurance I.A.R.D., peut être la réponse aux problèmes que représentent les expositions volatiles ou les sinistres à liquidation lente, engendrés par la responsabilité civile produits, la responsabilité professionnelle, la responsabilité civile pollution ou d'autres risques trop coûteux à assurer ou trop difficiles à placer sur le marché.*

Occupant un segment de marché restreint, la finite insurance *découle du principe qu'en contrôlant soigneusement l'exposition au risque, il est possible de souscrire des affaires rentables. Ainsi, en plaçant une limite sur l'exposition au risque, il est plus facile de prévoir ses résultats de souscription.*

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Finite insurance, one of the most talked-about products in the alternative property/casualty marketplace, may prove to be a significant new source of business for commercial insurers.

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* This article appeared in the Summer 1992 issue of *Insurance Executive Report*, under the title "Sizzling Hot". As mentioned in the front page of the article, "finite insurance, a risk-financing tool that picks up where conventional insurance and self-insurance leave off, is the latest buzzword in Bermuda."

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Before entering this narrow segment of the market, however, executives should recognize its limitations along with its potential benefits.

Finite insurance, marketed as shared risk, integrated excess, structured insurance and under other names, closely resembles several forms of reinsurance. The transaction can be either direct, as would be the case when it takes place between a professional reinsurer and a risk manager's captive, or indirect, as would be the case when the risk manager deals with a domestic casualty insurer affiliated with the reinsurer.

While no precise figures are available on the premium volume attributable to finite insurance, a great deal of media attention has been focused on the concept. According to various industry sources, $1 billion or more of new capital has poured into this market, most of it offshore, beyond the pale of state regulation and U.S. statutory accounting. At least one global insurer has written at least $400 million of finite insurance.

Finite insurance has carved out a meaningful niche in the alternative marketplace because it offers a way to deal with volatile or long-tail exposures like products liability, professional liability, pollution liability, and other risks that are either impossible to underwrite or too expensive to insure in the domestic property/casualty market. It can be used to meet the needs of risk managers that are not now being met by captives, pure self-insurance, and other alternative mechanisms.

True Risk Transfer

The finite insurance products being offered today are not to be confused with certain forms of financial reinsurance that ran afoul of insurance regulations and accounting rules. Finite insurance products incorporate true risk (of loss) transfer and are not simply mechanisms to treat timing and interest-rate risks. In structuring these transactions, players must take care to avoid the appearance that no risk has been shifted and that only the interest-rate, timing, and credit risks are being transferred.

Agreements that completely absolve the insurer from all underwriting, interest-rate, and timing risks should be avoided.

Finite insurance is the transfer of a maximum amount of aggregate liability for a negotiated price or premium. The liability being insured can be *retrospective*, as would be the case for a self-insurer with a "portfolio" of prior years' workers' compensation or products liability reserves. Or, the insurance may be written on a *prospective* basis. Increasingly, finite insurance is being packaged together with the underwriting, claims and other services of an admitted insurer, along with conventional excess of loss insurance. For example, assume that a qualified self-insurer has $5 million of loss reserve accruals for workers' compensation claims going back to the 1970s. The insurer's actuary determines that the present value of these losses is $3.5 million. For a premium of $4 million, the insurer agrees to underwrite up to $5 million in losses. As a result, the self-insurer pays $4 million, which after taxes costs only $2.7 million, to eliminate a current $5 million liability.

A more important benefit is that by fixing the expense for past liabilities, the risk manager no longer has to worry about fluctuations in loss reserves. Should these losses ultimately settle for less, the policy often contains a commutation clause that allows the insured to take back the losses and obtain a refund of premium, net of certain expenses.

Finite insurance is priced solely on the basis of the self-insurer's loss experience and unique exposures. The premium is made up of the following components:

(1) The expected present value of loss and allocated loss adjustment expense payments;

(2) Expenses for overhead, underwriting, insurance brokerage commissions, claims service charges, and premium taxes; and

(3) Insurance company profit.

With the exception of premium taxes, all of these components are negotiable. The respective parties come to the transaction with their casualty actuaries and their financial calculators. The insurance contract terms, generally developed by the parties' casualty actuaries, define the complicated mechanics. For example, the policy typically will contain a provision describing how interest earnings are to be credited to the experience account.

Readers familiar with conventional reinsurance agreements will recognize the similarities with older forms of reinsurance. The unconventional aspects are the market players and the risks being insured. The insurance buyer may be uninsured, as would be the case for risk managers with hazardous or costly exposures. Or, the buyer could be a state-qualified self-insurer of workers' compensation or a multi-employer workers' compensation pool, an insured under a retrospectively rated insurance policy, or a captive insurance company.

On the insurance industry side, a growing number of professional reinsurers are specializing in this market via affiliated insurers. Generally, the insurance company utilized is an alien insurer. This arrangement allows freedom from state regulation and premium taxes, absence of solvency and residual market loads, and the ability to use GAAP rather than statutory accounting. Offshore, Bermuda is the domicile of choice because of its proximity to many captives and its favorable regulatory and tax climate. Bermuda requires statutory accounting but allows discounting of loss reserves.

A new breed of intermediaries, with names still unfamiliar to many in the mainstream, have arrived on the scene. Some of these marketing organizations have ownership common to the new class of offshore reinsurers.

Future of Finite Insurance

Finite insurance clearly has met with the approval of risk managers. On the other hand, anecdotal information suggests that finite insurance is not of interest to every risk manager.

Depending on their differing cash flow, tax, and earnings constraints, risk managers may have reservations about these transactions. For example, these deals are cash transactions, generally $1 million at a minimum, and not all risk managers have idle cash available. And those that do have cash may be reluctant to lose control over the investment accounts into which the premiums fall.

Properly structured finite insurance appeals to many risk managers because it provides a means of converting a liability into a tax-deductible premium payment. Self-insurers are not permitted to deduct loss reserves. Wholly owned captives, too, cannot generally convert a loss reserve into a tax deduction. An insured under a finite insurance policy should be entitled to deduct premiums paid to a finite insurer or reinsurer. On the other hand, many risk managers' companies may not be paying the full corporate tax rate, and so would be less likely to find finite insurance attractive.

Moreover, many risk managers have not yet established loss reserves for uninsured or self-insured liabilities. Finite insurance works best when the premium is less than the reserves on the books, because the finite risk insurer will discount the losses. Thus, the discounted losses and expenses or premium may be less than the value of the losses accrued by the self-insurer.

Overall, finite insurance is a risk-financing tool that picks up where conventional insurance and self-insurance leave off. It offers insurance executives an opportunity to meet the needs of risk managers and to regain some of the premium dollars that have dropped out of the commercial market since the 1970s, when risk managers started to implement aggressive risk retention practices. Insurers that understand the needs of insureds and customize their finite insurance products to meet those needs will have the greatest appeal to risk managers.