

Fronting, retention and the international programme

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The fronting insurer carries a risk that is easy to overlook. It is liable to the insured subsidiaries in full, whatever the captive pays it under the reinsurance contract. If the captive fails, the fronting insurer must pay the claims from its own resources. For this reason fronting insurers usually require collateral from the captive, in the form of letters of credit, trust funds or parent company guarantees, while also scrutinising the solvency of the captive and of the group behind it. The relationship between fronting insurer and captive is therefore a credit relationship as well as an insurance relationship, which the parties document in detail.¹

Most captives of large groups sit within an international insurance programme. A master policy issued in the home country of the group covers the risks of all subsidiaries and pays the difference in conditions and limits where local policies are narrower. Local policies, issued in each country where the law requires a locally admitted insurer, provide the cover that local authorities, lenders and contracting partners expect. The captive takes a share of the risk in each layer, usually the lower layers in which losses are frequent and predictable, while commercial insurers and reinsurers carry the upper layers in which rare but severe losses occur.² The level of retention is a strategic choice. A group with a strong balance sheet can retain more and buy less commercial cover, whereas a group with volatile earnings or a heavy debt burden may prefer to transfer more of its risks.

The captive also opens a door to the reinsurance market. Reinsurers will often deal directly with a captive on terms that reflect the loss experience of the group, while a primary insurer adds its own costs, profit margin and assessment of the market. A captive can therefore buy protection at the reinsurance level and pass the saving on to the group. The data that the captive collects on claims, premiums and loss trends support the

negotiations with reinsurers and the decisions of the group on prevention. In the language of risk managers, the captive turns the cost of insurance from an external price into an internal variable that the group can manage.³

Several variations of the basic model have developed. A rent-a-captive allows a company to use the licence and capital of an existing captive owned by a third party, usually an insurer or broker, without setting up its own company. Protected cell companies and incorporated cell companies divide a single legal entity into cells whose assets and liabilities are segregated from one another, so that each cell can serve a different user. Guernsey introduced the protected cell company by statute in 1997, and several other domiciles have followed with their own cell legislation.⁴ Group captives, owned jointly by several companies in the same industry, pool risks that each member alone would find hard to insure. Risk retention groups in the United States serve a similar purpose for liability risks under the federal Liability Risk Retention Act of 1986.⁵

1 Notes

1. On the credit risk of the fronting insurer and the collateral customarily required from captives (letters of credit, trust accounts, parent guarantees), see the literature on captive insurance and the practice notes of the major fronting insurers. To be verified. ↩
2. On the structure of international insurance programmes (master policy, local policies, difference in conditions and difference in limits cover) and the position of the captive within them, see the literature on multinational insurance programmes and the publications of the major brokers. To be verified. ↩
3. On the access of captives to the reinsurance market and their function as a data and risk management tool, see the publications of the captive owners' associations and the risk management literature. To be verified. ↩
4. Protected Cell Companies Ordinance, 1997 (Guernsey), later consolidated in the Companies (Guernsey) Law, 2008; on cell companies and rent-a-captives as variations of the captive model, see the literature on captive insurance. To be verified. ↩

5. Liability Risk Retention Act of 1986 (15 U.S.C. §§ 3901 ff.), amending the Product Liability Risk Retention Act of 1981. To be verified. ↩

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