HAWAII CAPTIVE INSURANCE COUNCIL

CAPTIVE INNOVATIONS

Thinking Differently

2023

Empowered Captive Fronting

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HAWAII CAPTIVE INSURANCE COUNCIL

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SESSION DESCRIPTION

The arrangement of fronting is an often-overlooked facet of doing business as a captive. It's a critical necessity for many captives to have fronted arrangements to meet compliance, regulatory or contractual requirements.

In this session we will let you know the key qualities of a properly structured deal and we will explore the latest innovations using integrated technology tools that provide your captive with an edge.

What is Fronting?:

Fronting has been defined as the use of a **licensed, admitted insurer** to issue an insurance policy on behalf of a self-insured organization or captive insurer **without the intention of transferring any risk.** The risk of loss is retained by the self-insured or captive insurer through an indemnity or reinsurance agreement.

However, the fronting company (insurer) would be required to honor the obligations imposed by the policy if the self-insurer or captive failed to indemnify it. Therefore, the **fronting company is subject to credit risk** as a result of the arrangement, and fronting companies charge a fee for this service [and typically require collateral].

- Captive.com

What is Fronting?:

The risk of loss is retained by the self-insured or captive insurer with an indemnity or reinsurance agreement. However, **the fronting company (insurer) assumes a credit risk** since it would be required to honor the obligations imposed by the policy if the self-insurer or captive failed to indemnify it.

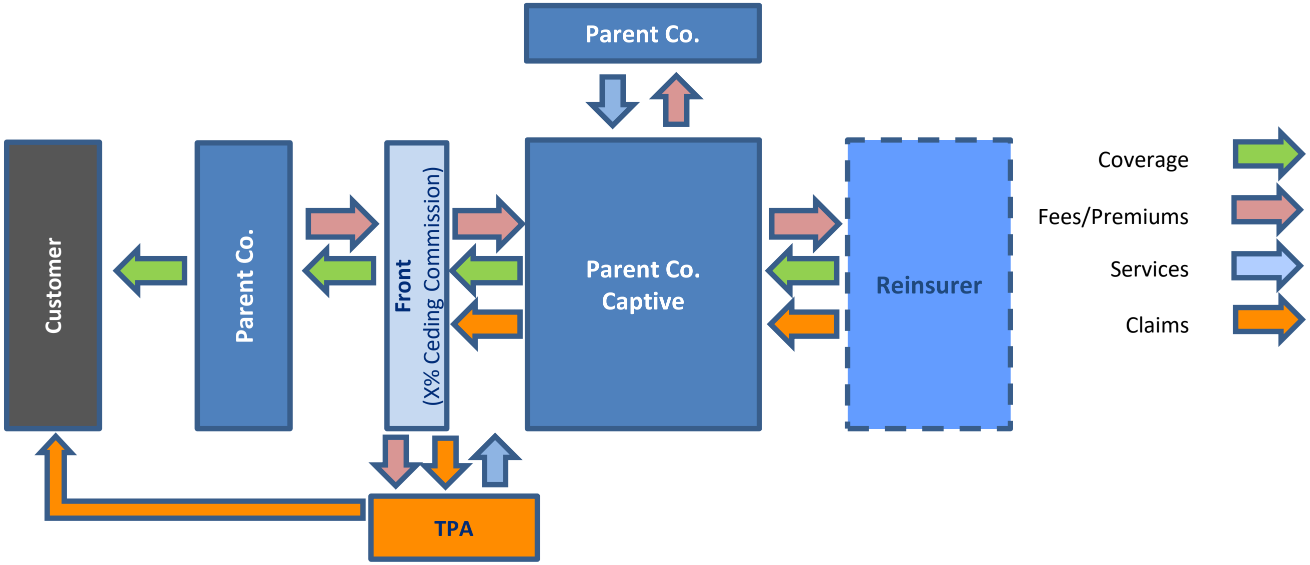
Fronting companies charge **a fee for this service, generally between 5 -10% of the premium being written**. Fronting arrangements allow captives and self-insurers to **comply with financial responsibility laws imposed by many states that require evidence of coverage written by an admitted insurer, such as for automobile liability** and workers compensation insurance. Fronting arrangements may also be used in business contracts with other organizations, such as **leases and construction contracts**, where evidence of coverage through an admitted insurer is also required.

-Insurance Risk Management Institute

Types of Fronting:

1. "Pure-play Fronting" - when the risk is completely passed through from the balance sheet of the commercial insurance company. This means that they have an agreement wherein they are not liable to pay any claims regardless of adverse events which may be faced by the insured. Since there is no risk involved for the insurance company in such cases, they tend to take over pretty much any risk just for a nominal fee.

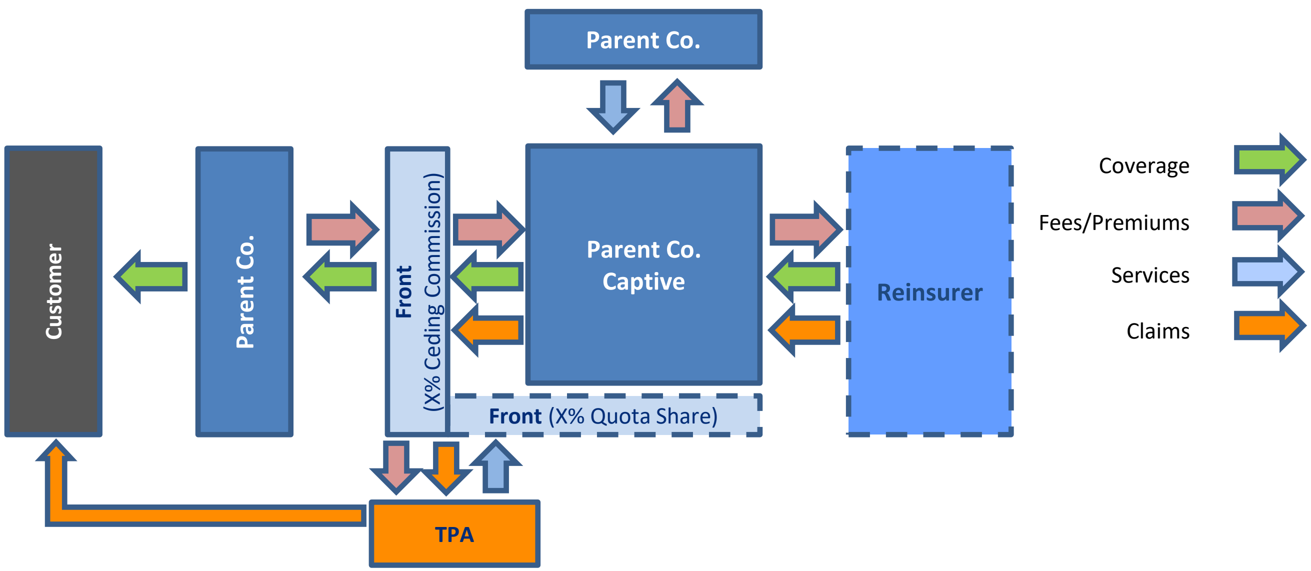
   - Management Study Guide: https://www.managementstudyguide.com/fronting-in-reinsurance.htm



Types of Fronting:

2. "Pro-rata Fronting" - fronting insurance companies may be required to pay a certain percentage of the claim. However, the risk percentage is very minimal i.e. around 10% to 20%, and the majority of the risk is still carried on the books of the captive reinsurance company. As a result, the commercial insurance company wants to make sure that the risk is compliant with its overall portfolio. The commercial insurance companies view it as a retrocession agreement and conduct a thorough study before taking over the risk on their balance sheet.

   - Management Study Guide: https://www.managementstudyguide.com/fronting-in-reinsurance.htm



Key Benefits:

- **Setting Policy Terms and Conditions** - some flexibility to provide broader coverages than are typically available under a traditional policy.
- **Direct Involvement with Claims** - the insured (or captive reinsurer) is responsible for all claim payments under the policy and allocated loss adjustment expenses (ALAE), the carrier may allow a fair amount of flexibility in claims administration.
- **Reduce / Smooth Upfront Premium Costs** - The carrier's fronting costs include:
  - administrative costs for policy issuance and servicing throughout the policy term,
  - costs to ensure regulatory compliance/filings (such as state auto filings, use of state approved forms, taxes & assessments),
  - claims oversight and/or support as appropriate, and
  - a general capital/surplus charge for premiums flowing through the insurer.

Chris Weber, Vice President, Old Republic
https://www.orrm.com/blog/fronted-policies-when-it-makes-sense

Key Benefits:

- **Effective Use of a Corporate Captive** – directly reinsure the issuing carrier's policy, or it might issue an internal deductible buy-back policy.
- **Added Primary Limit / Capacity** - often see lead umbrella policies requiring higher attachments. Possible responses are to increase the limits under the fronted primary policy to meet these requirements or to utilize a fronted buffer layer policy sitting directly above the primary policies
- **Increased Security Requirements** - This protects the insurer against insolvency by the insured or captive or other circumstances that might pose risk to the insurer.
- **Controlling Total Cost of Risk (TCOR)** - Retaining losses + ALAE (often major components of TCOR) can bring volatility to operating expenses. The insured's risk tolerance must be weighed against the cost savings.
- **Long-term or Short-term Solutions** - It is not unusual to see insureds decide to make use of a fronting policy as a tool to retain more risk and save current premium dollars in the short run, only to decide this is in fact the right long-term strategy.

Chris Weber, Vice President, Old Republic
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Key Elements for the Fronting Carrier

- Program Structure
  - Coverage, limits, retentions, & premium for captive participation
  - Multinational footprint – admitted, non-admitted, & FINC
- Exposures
  - Revenue, payroll, # of locations, # of auto, etc.
  - Loss History
- Collateral
  - Captives audited financials
  - Parental Guarantee, Letter of Credit, Bonds, Trusts, & Cash
  - Schedule F considerations
- Fronting Fee Drivers
  - Administration - # of countries, # of policies, # of certificates, # of invoices
  - Anticipated claim volume
  - Fronted limit & captive premium (central premium collection vs local invoices)
- Legal Contract(s)
  - Reinsurance Agreement or Indemnity Agreement

Fronting Appetite will vary by Carrier

- More Common Coverages
  - US Auto
  - US General Liability
  - US Workers Compensation
  - Property
  - Marine Cargo
  - Cyber
- Less Common Coverages
  - Excess Liability
  - Pollution Liability
  - Products Liability
  - Professional Indemnity
  - Multi-line
  - Trade Credit
  - Crime
  - Warranty Insurance

Pure Fronting vs Pro-Rata Fronting

Not all fronting carriers will provide Pure Fronting, a number of carriers prefer the Pro-Rata or having risk transfer included in the fronting arrangement.

About Flexport

Founded in 2013, Flexport is a freight forwarder (aka freight broker)

- Grown to become #6 in Transpacific Eastbound (APAC to NA) in less than 10 years with global operations in 87 countries & territories

Began offering cargo insurance in 2016

- Goal was to help our customers protect their cargo, and offer all services a client would need under one roof

Started with Per Shipment insurance, then introduced new offerings

- Introduced Annual Policies in 2021, Trade Credit Insurance in 2023, and 2 more set to launch in early 2024.

Grown insurance offerings into substantial standalone business

- Over 8K unique clients served, $13.6B in insurable value, 200K shipments covered, and a claim rate of ~0.3%

Insurance Structure at Flexport

Split between Commercial Insurance and Corporate Risk

- Two distinct and separate divisions of the company

Commercial Insurance places coverage with customers

- Licensed brokerage and sales team positioning policies to clients [Risk Placement / Revenue Generation]

Corporate Risk gathers coverage for Flexport

- Approaches markets for policies to protect our activities (eg, worker’s comp, E&O, aviation, freight forwarders, cyber, etc.) [Risk Transfer / Cost Avoidance]

Financial optimization opportunities exist for both groups

- We can insource risk for both groups, Commercial Insurance can achieve higher margins on mature programs, and Corporate Risk can reduce spend in the face of rising market costs

Why a captive?

Take advantage of Per Shipment (PS) program performance

- Mature program with 8 years of observations, high per transaction profitability and extremely low loss ratio

Drive improvement & offset commercial costs

- Commercial market costs were increasing every year; increased capacity was met with an increased price

Modify policy language to meet our needs

- Needed flexibility to adjust coverage to benefit our clients and achieve tech development

Experiment with a ‘two-way’ door

- Existing arrangement (carrier and policyholder) worked, but wanted to explore - what more the world of insurance could offer from unique entity structures and financial vehicles.

Captive Experience

Speed expectations

- Insurance markets are extremely slow relative to tech - temper your expectations

Internal alignment doesn’t end with preliminary approval

- Sequential filings, initial account capitalizations and maintenance requirements, and gathering executive personal information can’t be fully anticipated or appreciated at kick-off so be sure to set expectations with stakeholders

Cost of capital

- You may generate a sizable commercial benefit, but how does that stack relative to other efforts or investor money

Personal effort

- A captive is a substantial effort for any organization and if you’re the champion for it then expect major time dedication to seeing it through

Airbnb exists to create a world so that **anyone** can **belong anywhere.**









KEN






Airbnb's Global Scale

4M+
Active Hosts

7M+
Active Listings

1.5B+
Cumulative Guest Arrivals

220+
Countries & Regions

$180B+
Cumulative Host Earnings

Data as of 6/30/2023

Diverse Categories of Hosts and Guests

Guest

- Solo Travelers
- Couples
- Friends
- Families
- Work Trips

Host

- Home Owners
- Renters
- Property Owners
- Professional Hosts
- Property Managers
- Experiences Hosts

Airbnb Platform

airbnb.org

Opening homes in times of crisis

aircover

For Hosts

Top-to-bottom protection.
Free for every Host.
Only on Airbnb.

aircover

For Guests

End-to-end protection.
Free for every guest.
Only on Airbnb.

Only Airbnb gives you AirCover

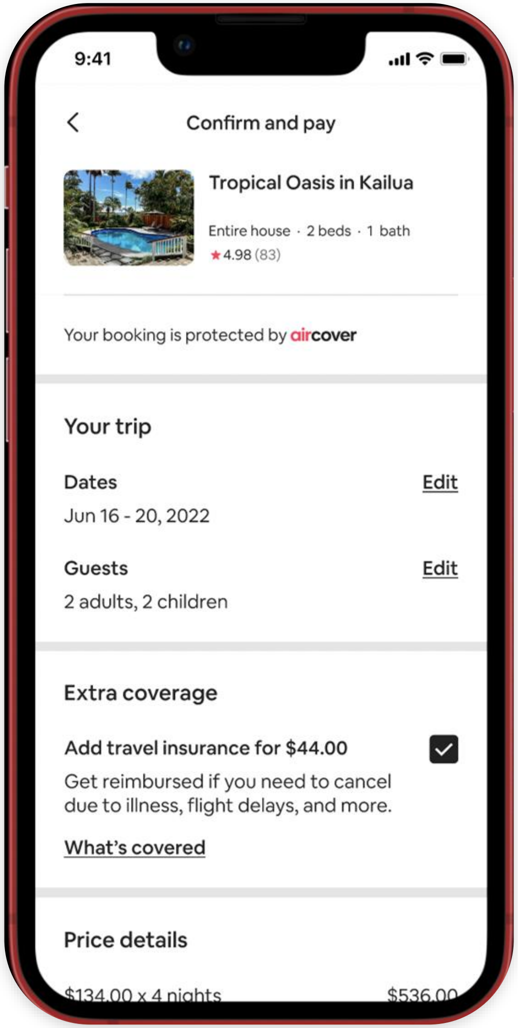
aircover
For Hosts

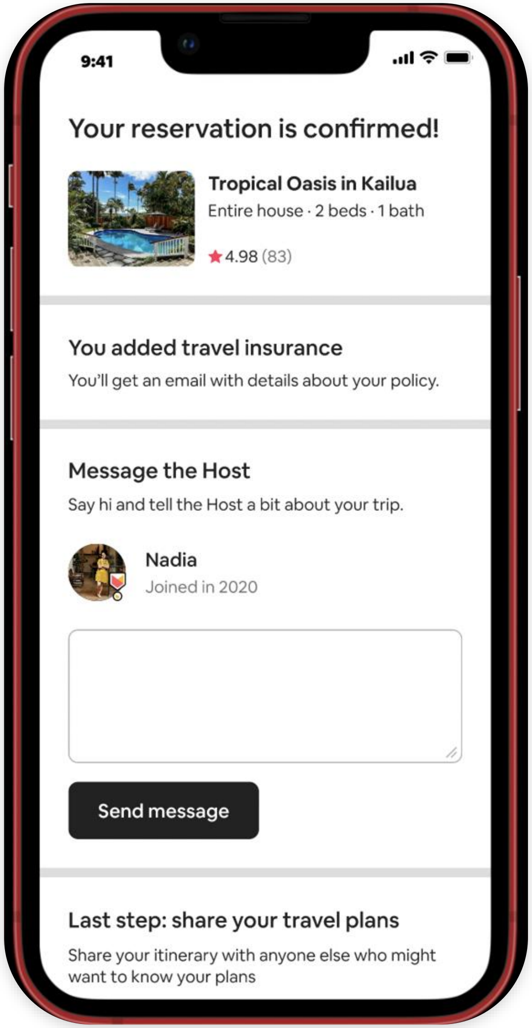
Top-to-bottom protection.
Free for every Host.
Only on Airbnb.

	Airbnb	Competitors
Guest identity verification	✓	✓
Reservation screening	✓	✗
$3M damage protection	✓	✗
Art & valuables	✓	✗
Auto & boat	✓	✗
Pet damage	✓	✗
Income loss	✓	✗
Deep cleaning	✓	✗
$1M liability insurance	✓	✓
24-hour safety line	✓	✗

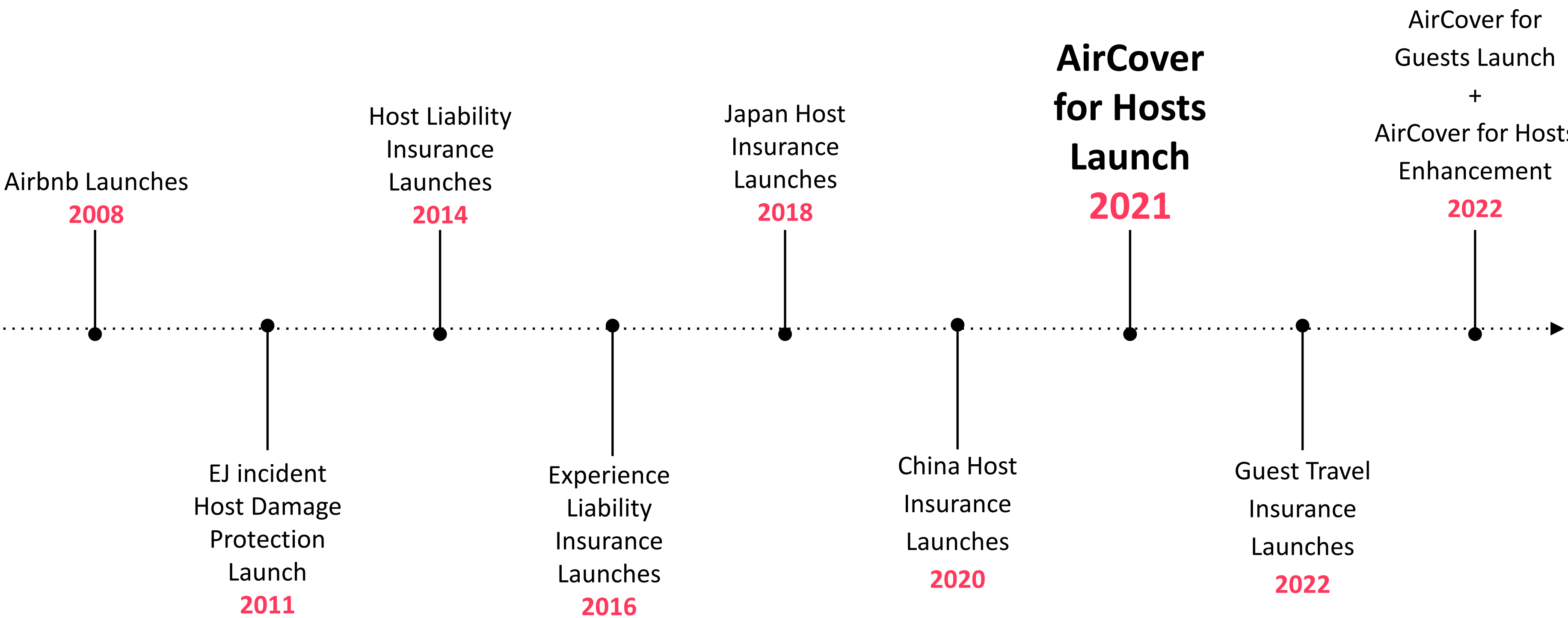
Guest Travel Insurance

Designed specifically for Airbnb Guests





Program Timeline

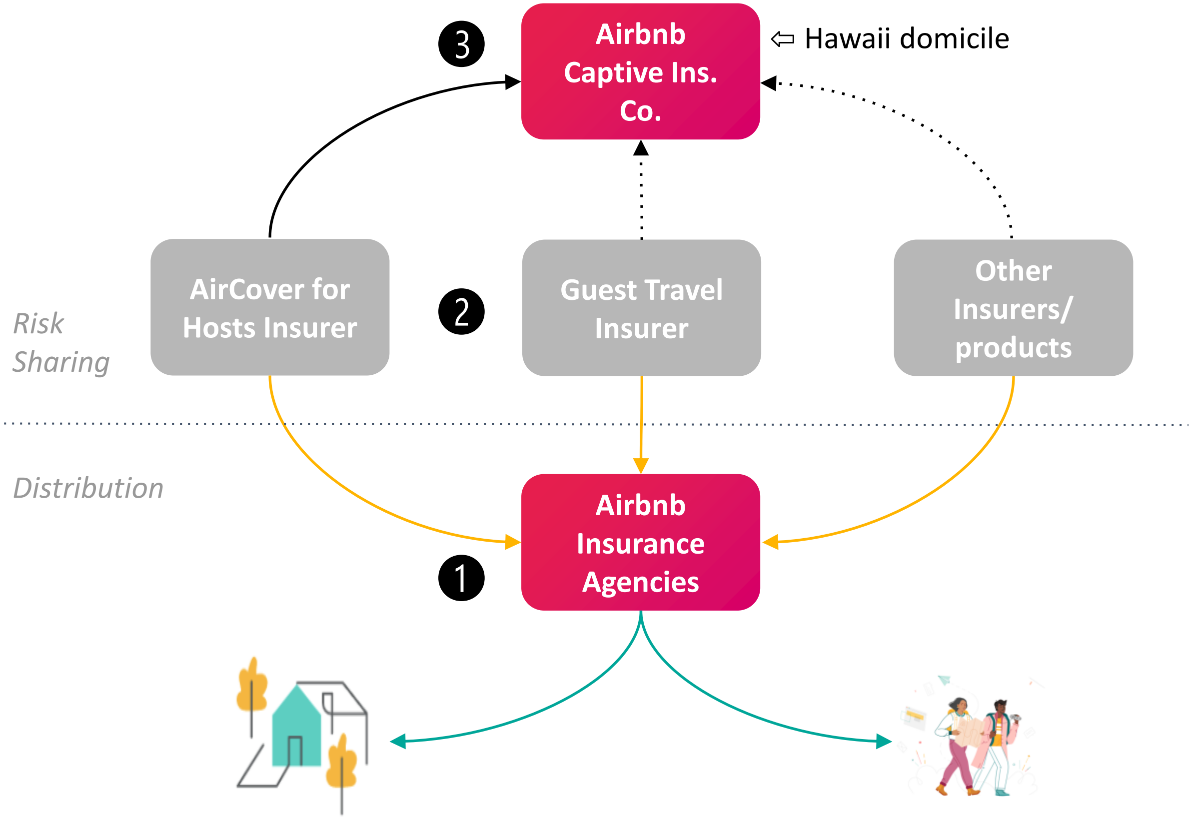


Airbnb's Insurance Entity Ecosystem

1. Airbnb's **Insurance Agencies** are licensed to sell insurance policies directly to guests & hosts

2. We work with large global **Insurance Brokers & External Insurers** to issue insurance policies and implement our programs

3. Airbnb's **Captive Insurance Company** is used to reinsure these programs, managing our financial exposure and cost



Note: Simplified view, not inclusive of all parties.

Mahalo.
This concludes our presentation.