



# Hard Market Alternatives

(Alternatives to conventional insurance  
and their corporate finance value)

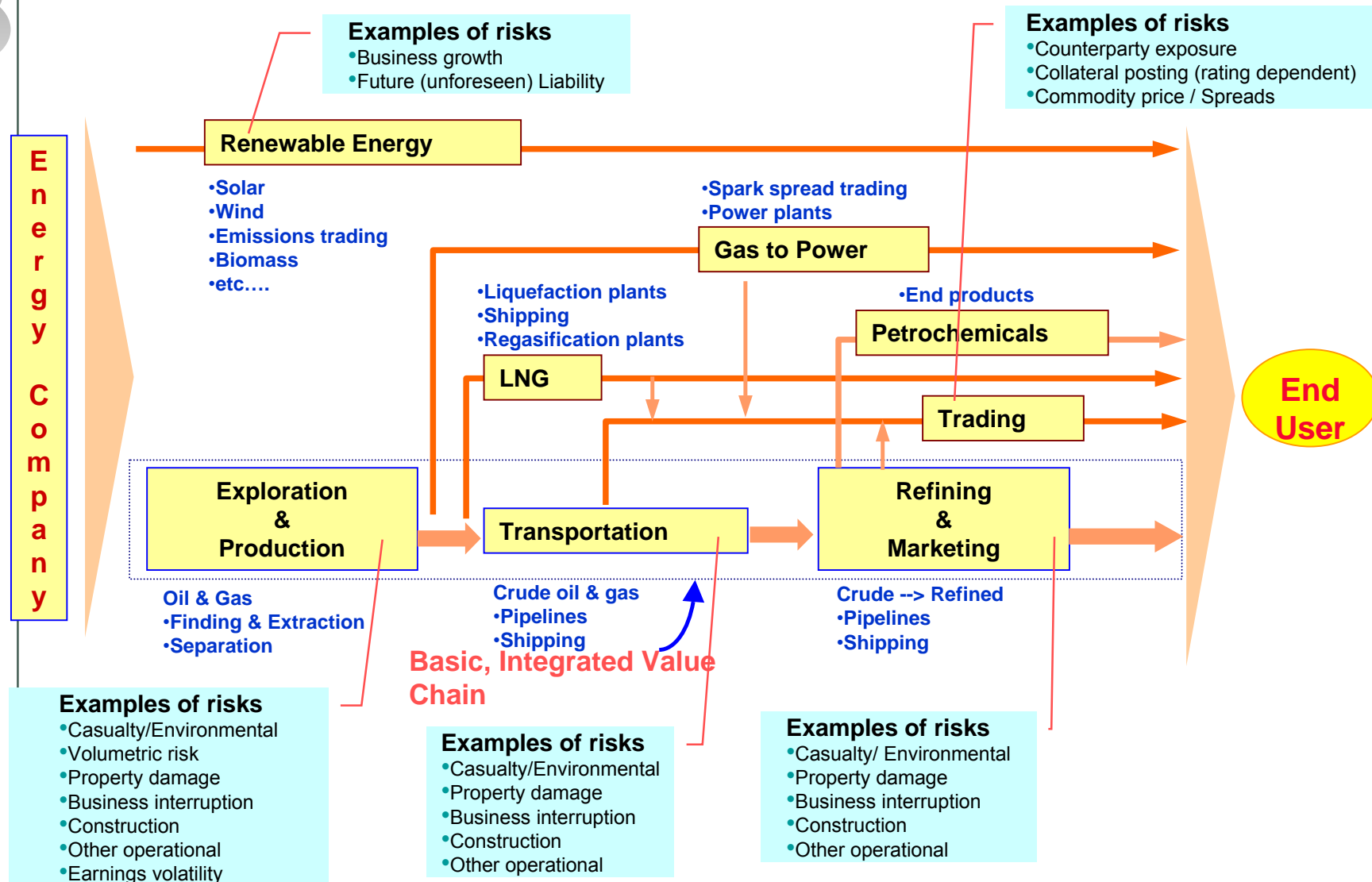
## Presentation to OPERA

London, 21st January 2003



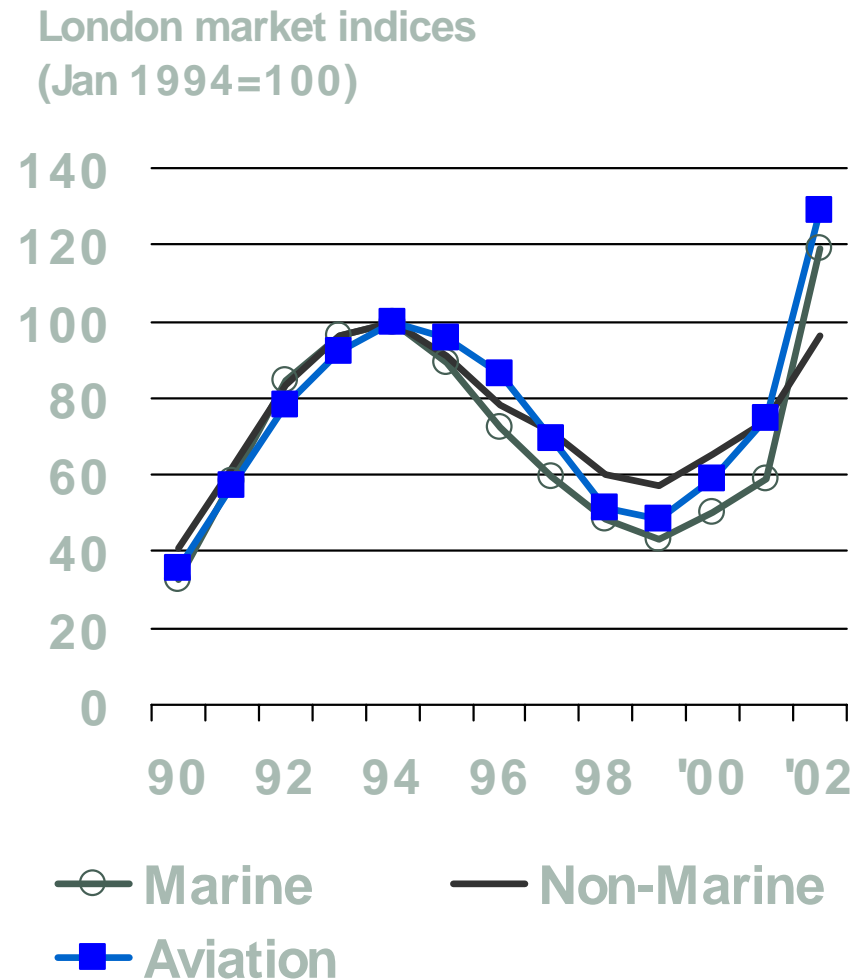
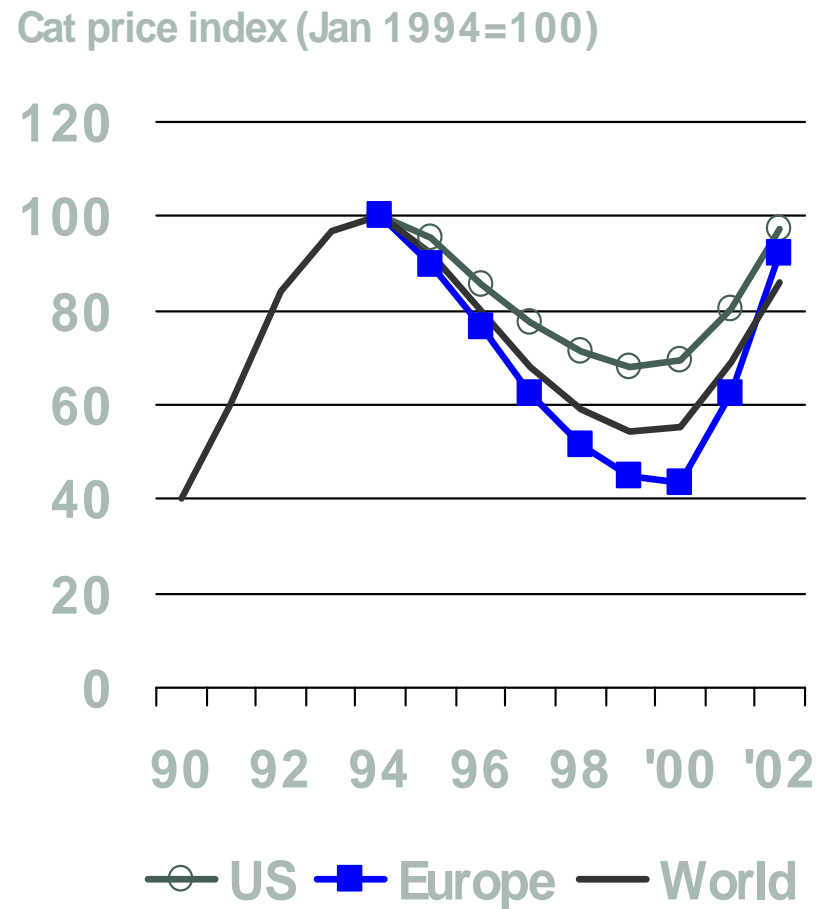
# The Energy Value Chain is full of Risks....

“How much falls between the cracks?”



# Companies renewing p&c lines in 2002 faced sizeable premium increases

Swiss Re



# Corporate treasurers should re-evaluate how they use the market

Swiss Re



- “Insurance cycle” risk managers (who only buy when it’s cheap) will stay out
- Retention and limit practices must be rigorously examined
- More broadly, alternatives to conventional risk transfer should be analyzed

# What corporate finance objectives should insurance achieve?



- Keep shareholders from bearing risks they don't want in owning your stock
- Reduce impact of non-core events on earnings
- Reduce capital required to support debt capacity needed to finance infrequent loss events
- Enhance financial flexibility:
  - diversify funding sources by using the insurance market
  - insure access to liquidity for funding losses
- Signaling:
  - clarity in identifying and managing risks;
  - avoid disclosure “noise” about things that are ancillary to core strategy;
  - regulatory or quasi-regulatory compliance



## Options include risk financing as well as traditional risk “transfer”

- Traditional insurance has elements of financing, since the market seeks to be “paid back”
  - Underwriting losses are recovered by the market via higher rates in the macro cycle
  - At the micro level, companies who make claims are priced as higher risks
- As financing, this has some peculiarities
  - Availability, term and rate are unknown beyond one year
  - Financing cost driven by equity market returns and broad underwriting losses



# Faced with a gap, companies have four options

<b>Do nothing</b>	Leave the risk uninsured, keeping it with your shareholders.  If a loss occurs, absorb it as an operating cost and leverage your capital base to finance it
<b>Pay the high rates</b>	If capacity is available at some price, pay the price.  If a loss occurs, make a claim (which the market will try to recover from you later, in indeterminate amounts and duration)
<b>Use finite structures</b>	Enhance existing insurance with tax-efficient self-retention  If a loss occurs, make a claim, reducing the premium return based on the terms of the finite
<b>Use committed capital</b>	Secure targeted capital availability contingent on the loss event occurring.  If a loss occurs, replace lost capital using committed capital facility



# Objective satisfaction: Do nothing

**Protect shareholders from unwanted risk**

Has opposite effect of objective

**Reduce impact of non-core losses on earnings**

Does not provide protection

**Use capital efficiently**

Ties up capital, since losses may need to be financed

**Enhance financial flexibility**

Detracts from financial flexibility, since financing losses will use up available funding

**Signalling**

Does not respond to risk aversion of shareholders  
May be misleading by not identifying uncovered risks



# Objective satisfaction: Pay high rates

**Protect shareholders from unwanted risk**

Meets objective by shifting risk to insurance market

**Reduce impact of non-core losses on earnings**

Protects earnings from losses

**Use capital efficiently**

Frees up capital for uses that may generate return better than premium

**Enhance financial flexibility**

Uses insurance market as a funding source and protects company from needing to finance losses

**Signalling**

Depends on terms



# Objective satisfaction: Finite solutions

**Protect shareholders from unwanted risk**

Builds reserves against identified risks

**Reduce impact of non-core losses on earnings**

Reduces volatility of earnings by absorbing losses through finite policy

**Use capital efficiently**

Tax-effective build-up of reserves that are capital equivalent

**Enhance financial flexibility**

Neutral impact – uses company's own earnings to provide for risk

**Signalling**

Clear signal that management is aware of and has provided for risk  
Delivers disclosure and other benefits of insurance



# Objective satisfaction: Committed capital

**Protect  
shareholders from  
unwanted risk**

Reduces risk to shareholders of capital adequacy

**Reduce impact of  
non-core losses on  
earnings**

Does not protect earnings

**Use capital  
efficiently**

Provides „just in time“ debt capacity

**Enhance financial  
flexibility**

Taps an alternative market in an additive way and protects credit rating from dilution with senior debt for loss funding

**Signalling**

Shows clear recognition of risk and that management has a plan to deal with it

# Summary: How well are the corporate finance objectives met?



	Protect shareholders from unwanted risk	Protect earnings from impact of non-core losses	Use capital efficiently	Enhance financial flexibility	Management signalling impact
<b>Do nothing</b>					
<b>Pay the high rates</b>					
<b>Finite structures</b>					
<b>Committed capital</b>					



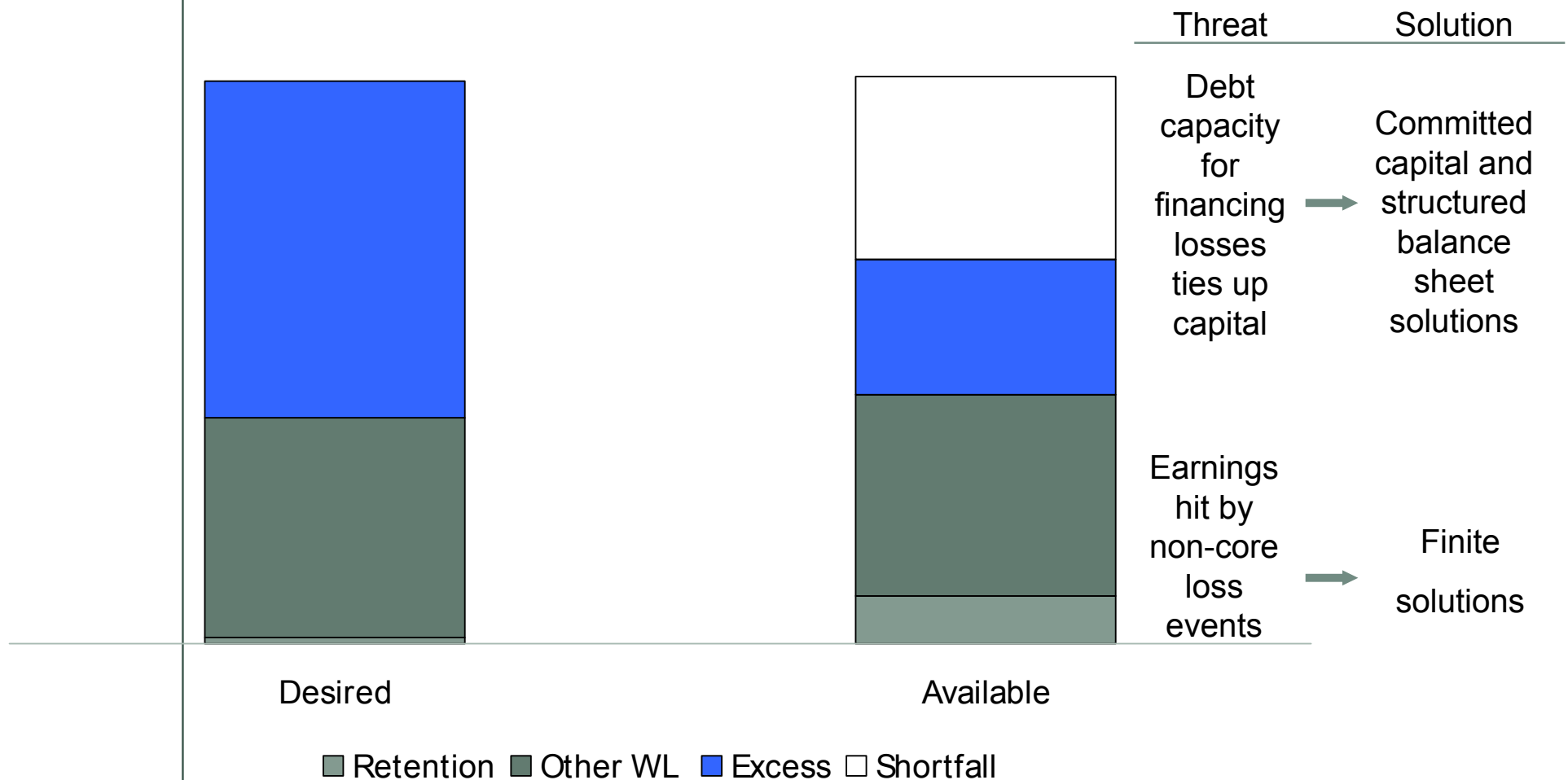
## What does this tell us?

- Doing nothing will rarely satisfy typical corporate finance objectives
- Paying high rates at the top of the cycle meets objectives, but at a cost
- Self-retention of a significant amount of risk saves this cost, but should be structured
  - Finite solutions deliver well on tax and earnings protection fronts. Works well for higher frequency and retention layers
  - Committed capital solutions deliver better on protecting capital than on protecting earnings. Works well for high-excess, low-frequency layers



# How should this affect your program?

Market creates threats at top and bottom of typical program





# Next steps include analysis of financial impact . . .

## Option

Do nothing  
 Pay the rates  
 Finite solutions  
 Committed capital

## Impact on performance metrics +

perception  
 EPS after tax  
 Balance sheet ratios  
 Financial flexibility  
 Investor perception of management  
 Disclosure  
 Other constraints

## Translates into shareholder value

EPS change effect on share price  
 Credit quality change effect on debt value  
 Economic value of solution DCF



# . . .as well as tax and accounting treatment

<b>Impact of a loss on:</b>	<b>Earnings</b>	<b>Balance sheet</b>
<b>Do nothing</b>	Reduced by after tax loss	Loss must be financed, which requires capital
<b>Pay high premium</b>	Reduced by after tax premium	No change
<b>Finite</b>	Reduced by after tax carrying cost	Depends on treatment of experience account balance
<b>Contingent capital</b>	Reduced by after tax fee	Capital increases as needed to provide financing