

Chapter One : Introduction

< 1 > Study motives

For insurance companies, risk management also has a central role in a corporate operation. Insurance companies frequently manage underwriting risks by purchasing reinsurance because it reduces downside risk (i.e. bankruptcy risk), less volatility and less probability of extreme values.

Taiwan non-life insurance companies face an increasing array of underwriting-risks, including earthquakes insurance, fire insurance, business interruption coverage, product liability insurance, directors and officers liability insurance, weather insurance etc. The approaches that insurers apply to manage these risks will have a great impact on their market values, risk of bankruptcy and financial distress. New risk classes frequently challenge the limits of insurability.

Since Taiwan non-life insurance companies now face an increasing array of underwriting-risks, the high uncertainty may cause insurance company managers highly depend on reinsurance mechanism. Take statistics data of Taiwan non-life Insurance Industry in 2003 as example, if we exclude automobile insurance, the overall retain premium is only 27.2%. In some cases, highly depend on reinsurance mechanism may reflect the agency cost between shareholders and risk-averse, career-conscious managers with salary basis payoff.¹ Our ceding ratio is apparently too high. One may doubt that whether reinsurance mechanism is the

¹ The agency cost may arise because the shareholders want to maximize the firm value while a risk-averse manager with career concern prefers to maximize his own welfare. If the payoff of the career conscious manager is on salary basis, it may leave manager too conservative.

optimal risk management strategy since our insurance company managers highly depend on reinsurance mechanism. Is it cost efficient in insurance operation?

In addition to traditional reinsurance, Alternative Risk Transfer (ART) also provides a wide range of solutions to meet the risk transfer needs of corporations. According to the term defined by Culp (2002), “ART products are contracts, structure, or solutions provide by insurance and/or reinsurance companies that enable firms either to finance or to transfer some of the risks which they are exposed in a nontraditional way, thereby functioning as synthetic debt or equity in a capital structure.²” The traditional products tend to be generic in nature with standard contracts, while the ART products tend to be customized for the individual client’s needs of risks. Traditional reinsurance had more of an isolated mono-line approach to risks. Increasingly complex risks and sophisticated risk management called for an integrated approach to corporate risks. ART solutions were developed to address such needs and reduce the cost of risks over time.³

Protected Cell Company (PCC) , an innovative development in jurisdiction such as Guernsey⁴, is one of the ART products or solutions. The use of protected Cell Company (PCC) structure is one of the significant development in the world of corporate finance for many years. It is intended to offer a level of flexibility in risk finance technology and used to provide a platform for broad range of financial transaction, including the provision of a stable and cost-effective platform for rent-a-captive, securitization and other transformer activities as well as diverse

² C. Christopher (2002) , 352

³ Swiss Re, “The Picture of ART” Sigma No.1/2003, page 12

⁴ N. James (2001) , 4

range of more conventional insurance and other financial applications.

The purpose of this paper is to explore the structure of PCC and analyze the feasibility of PCC for Taiwan non-life insurance industry. As mentioned above, PCC is a flexible new technology. Thus this paper will focus on the feasibility of PCC when it is used as Rent-A-Captive, by the analysis of their cost of risks, to study whether PCC has much more cost efficiency than reinsurance mechanism.

< 2 > Study Objectives

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< 3 > Conceptual Framework

The conceptual framework of this thesis is as figure 1-1.

Figure 1-1 : Conceptual framework

