THE MANY HATS OF A MIDDLE MARKET CFO

Megan Brooks, ARM, vice president of operations at Capstone Associated Services, Ltd. speaks about how CFOs balance risk and profitability through their new role as risk managers

Megan Brooks

Megan Brooks brings over 10 years of operational experience in the captive insurance industry. She oversees operations and regulatory compliance support for more than 100 individual captives, including providing guidance and management of captive asset allocation, solvency, reinsurance programmes and corporate financing transactions.

The risks that companies face today are increasingly complex, calling for robust risk management strategies. In larger corporations, entire teams are dedicated to the analysis and mitigation of risk. Due to potentially limited resources, middle market CFOs are facing significant challenges as their roles expand to include the responsibilities of a risk manager or chief risk officer. As financial decision-makers, CFOs are contending with industry and sector risk exposures, changes in laws, and shifting political winds.

The evolving insurance market offers options for the mitigation of risk including commercial coverage, self-retention, and other alternative strategies, which include captive insurance. Many factors affect whether CFOs decide to hold steady in their current risk structure or move forward with new, 'untested' strategies. But more often than not, uncertainty and fear stymie decision-making and place CFOs into a frustrating, almost paralytic holding pattern. The reality for them is that the wrong move puts profits at risk. As a CFO balances his/her roles, risk management should be carried out with a tempered approach in tandem with guidance from trusted experts in the insurance industry.

Potential changes in the cost of risk and the manner in which budgeting should be carried out are the biggest motivators (or de-motivators as it were) for risk strategy decision-making. Unbeknown to the CFO, this resistance to move forward with an alternative risk plan gives way to more familiar, but often times expensive financial planning methods. Commercial coverage, in addition to self-retention (absorbing loss expenses into the operating business), is unquestionably the easier route, safeguarded by more predictable financial models. CFOs have a historical record to draw from. Existing insurance policies can be renewed; expense projections can remain constant within a range.

But the unfortunate reality is that traditional risk management strategies may be draining company profits. For example, commercial insurance policies are often plagued with exclusions or 'gaps' in coverage. Loss expenses are absorbed by the company, lowering profit margins. The costs of insurance premiums are high and at times volatile, depending on a hard or soft insurance market. But there are strategic risk management alternatives, such as captives, that can provide more comprehensive coverage, which can also lower the cost of risk.

A captive is a property and casualty insurance company formed to insure the risks of a parent or affiliated company. It has provided numerous risk management and cost-efficiency benefits for middle-market organisations and their adoption is growing exponentially year-over-year. Introducing captives into a risk management strategy has great potential to fortify risk coverage initiatives, recover control from the commercial insurance markets, and improve efficiency within their operating businesses. Using the captive approach, the status quo can take the proverbial back seat while CFOs take the wheel and fully embrace their role as chief risk officers.

The expanding role of the CFO

The role of the CFO has expanded over the past 25 years. CFOs have moved away from the perceived 'glorified accountants' to trusted in-house advisors. They are providing key metrics and insight into their company's ability to survive financial threats and losses. They are an integral component of an executive team, spearheading initiatives that not only address financial concerns, but strategies that promote success in achieving company-specific goals. CFOs work beside the greater operational goals of the company; transactional and cost efficiencies are primary focuses.

Traditionally, CFOs are responsible for making a wide range of decisions, including those on capital structure, auditing and reporting, business and tax planning, capital expenditures, budgeting, and investor relations. For middle-market companies specifically, CFOs, in the absence of a risk manager, often by default have assumed the risk assessment and mitigation role. CFOs typically take an empirical, high-level approach. However, measuring and understanding the entire risk management process requires consideration of historical loss expenses, documented industry exposures, the cost of commercial insurance policies and more.

This type of risk assessment demands an analysis on a micro level. Common risk assessment techniques include risk registers, risk mapping, and a SWOT analysis; these are helpful in the identification of both existing and emerging risk exposures. The SWOT analysis examines "strengths, weaknesses, opportunities, and threats" to a company as a pathway to understanding how the cost of risk affects its overall financial health.

A thorough risk assessment technique helps uncover risks that a CFO may overlook, yet a risk manager would easily identify. For example, the identification of hazard risk and understanding of its full effect on the company can be a struggle for CFOs. Hazard risk is typically covered by commercial insurance; a premium is paid to transfer the risk off of the balance sheet. A risk manager also understands the immediate effect on operations and potentially how to mitigate future losses. In order to be effective in a CFOs, expanded role, they must assess all loss exposures and analyse the total cost of risk for their organisations.

Indecision and its financial impact

Many CFOs are finding that self-retention, regulatory changes and external environmental factors (like changes in laws) are having a long-term negative financial impact. For example, healthcare providers are navigating The Affordable Care Act, bearing risk exposures from "capitation contracts". Under capitation, medical providers are paid a set amount for each patient. It is up to each provider to determine how to use the allotted capital. Taking on this "provider-sponsored risk" and following the volume-to-value model can mean these medical capitated risk taking providers earn either more or less per year, creating an uncertain financial outlook. Additionally, healthcare providers have to contend with more federal restrictions, regulations and penalties. The cost of risk in the industry has increased and the current political narrative surrounding healthcare is another reason why the future remains uncertain for the industry.

Middle-market businesses in every industry have uninsured risk exposures resulting from inadequate conventional market insurance. Pollution from oil spills, overfishing adversely which affects the production of other fishing companies, equipment breakdown in construction, market fluctuations, regulatory changes, etc., the list goes on. Increased taxes, company expenses and other financial pressures compound the problem.

This is why the decision to move forward with an alternative risk financing plan addressing enterprise risks as a whole makes sense for the CFO, whose obligation it is to overcome uncertainty and implement hard-hitting, effective strategies that improve risk management, reduce the cost of risk and increase profitability.

Captives and middle-market CFOs

To fully embrace an alternative risk strategy, CFOs should consider the benefits of forming a captive insurance company. Captives have the ability to reduce the cost of risk by reducing self-retention and more efficiently finance losses. The tailored coverages written under a captive ensure that out-of-pocket costs for loss events are minimised or eliminated.

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Several major benefits of captive ownership include:

- The ability to take back the control over the company's risk management strategies
- The availability of tailored coverages that fill the 'gaps'
- Increased cashflow through reduced cost of risk
- A 0% federal income tax rate on premiums under Section 831(b) of the Internal Revenue Code with a cap of $1.1m ($2.2m starting on 1 January 2017)
- Capital expenditure control, where financing is available through the captive to affiliated entities instead of through commercial lenders
- The availability of other legal structures for larger businesses

The unique benefits of captive insurance companies are realised when CFOs partner with a captive management team with the right expertise to carry out the planning. Captive insurance planning requires the design and ongoing oversight of a professional team of corporate, tax, insurance and regulatory lawyers, along with tax accountants with insurance expertise. Property and casualty insurance professionals such as CPCUs, CICs, ARMs and claims managers are also required.

Partnering with an integrated captive management company ensures that the many moving parts of captive management are addressed, from the initial feasibility study (which determines the true risks of an organisation) to the ongoing management.

CFOs' fears about ambitious risk and cost management decisions can be quelled as long as the right people, the right coverages, and the right support are in place.