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COMMERCIAL RISK EUROPE CAPTIVES REPORT 2020

Captives: Next generation

There has been a lot of talking up of captives during the last few years, with momentum growing in the last year or two, and a feeling that a new dawn was approaching for the sector. That time is now here.

The traditional insurance market has properly hardened, in some cases, such as D&O, rapidly and severely. It is not just pricing, but tougher terms and conditions and an increasing number of exclusions. This, combined with the insurance industry's response to the pandemic, and to emerging risks such as cyber, has led many risk managers and insurance buyers to look to their captives to help close the gap between the risks faced by organisations and the insurance cover that is offered by the market.

But there are opportunities too to look beyond property and casualty, and there is considerable scope for captives to move into the employee benefits arena, if only risk management and HR departments can find common ground and stop working in silos.

This year's report brings together the views of captive owners, risk managers, captive managers, brokers, consultants and fronting insurers to discuss the growing role of captives, with a particular focus on Europe and Asia-Pacific.

The report explores the possibilities for captives in the third decade of the 21st century, looking at how to bring the captive to the centre of an organisation's risk financing programme, and even take on an expanded, strategic role.

Many thanks to all our sponsors.

Tony Dowding
Editor, International Programme News

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Captives: now is their time

◇ HARD MARKET

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It's been brewing for a long time. Prices increasing, capacity shrinking, terms and conditions getting more restricted. The 'hardening' market is showing signs of becoming a full-on, no-holds-barred hard market. Add into the mix emerging risks, the ever-increasing cyber threat, climate change and increasing natural catastrophes, and risk and insurance managers are working harder than ever in a difficult environment to protect and support their businesses. And then came Covid-19.

What all of this means is unprecedented levels of uncertainty and change. And what many businesses are looking for is certainty and stability in their risk financing and risk management. So, it is no surprise that many have turned to captives – either in terms of looking at new options, or at the captive solution for the first time, or making much greater use of existing captives.

The captive market has been around for many decades and is a mature risk financing market, but as Tony McHarg, head of multinational, international, AIG, explains, there are still opportunities: "There has been plenty of discussion about the saturation of the captive market and how most large companies already have one or more captives. Despite that sentiment, we still see growth opportunities in several areas: small- and mid-sized employers grouping together with likeminded employers to share in a portion of risk as part of an overall self-insurance strategy; large- and mid-sized companies looking to retain more of their P&C risks such as their workers compensation, general liability and property deductible layers; and large companies in new emerging markets, such as Latin America and Asia-Pacific, where captives are gaining in popularity due to the advantages captives can offer and the existing sophistication of large companies in those regions."

Peter Carter, head of global captive practice, Willis Towers Watson, says the general hard market cycle brings forward risk financing opportunities for operators in the captive management sector to explore. "In Europe, with a backdrop of high levels of insurance premium tax in some countries, the captive risk financing solution for large national corporates is not always commercially viable, especially in those jurisdictions with levels above 20%. However, we have noticed clients that are knowledgeable about captive technology, financing and risk management benefits from past forays are reawakening their interest in revisiting the concept as market rates harden," he says.

"Clients that are knowledgeable about captive technology, financing and risk management benefits from past forays are reawakening their interest"

The Covid-19 pandemic has exacerbated a market that was already hardening

Much of this is backed up by a client survey carried out by Marsh as part of its latest captive report – *The 2020 Captive Landscape Report: Captives Offer Value in Uncertain Times*. The client survey found that a majority of captive owners plan to increase their use of captives in response to changing insurance market conditions. More than half (59%) expected to expand their captive use by adding more lines of coverage, increasing retentions in the captive, or forming an additional captive.

"Globally, captive utilisation continues to soar, as evidenced by growth in the various lines of coverage written. The main reason for this increase is the tightening of the insurance market. Increases in 'all-risk', D&O, supply chain/BI, and CBI point to a dramatic change on

the horizon for next year," the report notes. "Coverages written by Marsh-managed captives that have shown steep growth in gross premiums by percentage in the past year include many non-traditional lines. Exposures influenced by changes in credit markets, investment yields, tariffs and trade can make commercial insurance options less financially attractive. As a result, more captives are insuring risks such as trade credit and surety, and funding longevity risks."

Matthew Latham, CUO, global programmes and captives at AXA XL, says he would expect to see an uptick in the short to medium term in the formation of new captives, and in the amounts of risk covered within captives, as the market continues to harden. "If a company believes their risk profile hasn't changed, but are nonetheless faced with increasing risk transfer costs, then it is logical to retain more risk if they have the financial capacity to do so, and a captive is the perfect vehicle for that," he says.

He notes that the region that looks most ready for growth in captives is Asia: "However, that's been talked about for many years and so far, while there has been growth, it's not been at the levels predicted. Perhaps a hardening market will provide the impetus for more Asian companies to form captives in the coming years?"

In terms of industries, he points to growth in captives among technology companies: "There are many tech companies that just five years ago either didn't exist or were quite small and that, today, are worth billions. And some of these firms that are growing rapidly recognise that a captive can be a valuable part of their risk financing programmes."

He adds: "For these companies, cyber risks, in all their myriad forms, are one of their most significant and challenging exposures. And captives can offer an effective solution for managing and mitigating these risks. For large cyber exposures, there may not be enough affordable capacity in traditional markets for these companies. Captives can supply some of that capacity, either by taking the first layer of risk or by providing extra capacity on a quota-share basis. The captive also can facilitate access to reinsurance capacity."

Derek Bridgeman, managing director, Strategic Risk Solutions (Europe), says: "Multinational groups that previously were too small to justify the frictional cost and administration required for a captive are now re-evaluating the viability of a formalised form of risk retention such as a captive/cell. Substantial increases in premium and deductible levels being enforced by the market mean they have often reached a level at which point it makes financial and strategic sense to implement a captive structure. The expectation is that these market conditions will continue to worsen over the coming period, thus it is likely that captive owners will continue to explore whether a captive can mitigate these challenges."

STRESSED LINES

Recent increased interest and growth in captives seems to be in response to the challenges that brokers and clients are facing in the market, according to Mr Bridgeman. "We are seeing this across all geographies and industries, however there are certain areas which seem to be challenged more," he says. "Financial lines renewals, professional indemnity and directors and officers (D&O), have been particularly challenging with significant premium and deductible increases."

Willis's Mr Carter also highlights D&O as a particularly stressed line: "In the last six months, in the boardroom of many of our Europe-domiciled captives, we have witnessed clients express dismay and concern about their D&O insurance renewals. In the vast majority of cases, the captive has not participated in the parent company's programme design. What clients have asked is: 'Can we write the cover? Yes or no? If yes, do we have the licence to do so? If not, can we resolve? What amount of capital would we need to write a selection of example limits on various Sides A, B and C of the D&O coverage?'"

Matthew Latham of AXA XL expects to see an uptick in the formation of new captives in the short to medium term

He says Willis has had specific cases now where for the first time they have been put in contact with clients' D&O brokers to work through the next renewal programme and work on a design to show how a captive participation on the programme could be advantageous for the parent group.

"Just in the last month, we bound a deal for a global services business where the broker targeted the main carriers on the programme to focus on capacity for Side A and let the captive take on the global placement, a significant line on Sides B and C. Initially, the captive was expecting to write a line on the primary layer, but the final solution saw the binding of an excess layer placement," he says. "The move was tactical and the client was pleased a solution was secured even though the rates on line priced by the market for the entire programme were more than double that from 2019. We expect to see this trend repeated over the coming months and in to 2021."

DIVERSIFICATION

There is increasing diversification in the risks going into captives, according to AXA XL's Mr Latham, but this is not a new trend, he says,

noting that the requirements of Solvency II and other risk-based solvency regimes created greater incentives for captive owners to look for opportunities to increase premium volumes and expand the span of risks covered by the captive.

"So, we see more and more captives pursuing a strategy that involves creating balanced portfolios that include a mix of short- and long-tail liabilities; some that are predictable, and some that are less so. Aggregating these within a captive can help reduce volatility, and a diversified captive can realise greater capital efficiency," he says.

There has also been growing interest in cell captives as opposed to wholly-owned captives, largely because it enables companies to avoid the costs involved in setting up a standalone captive. "It also can be a sensible approach for companies that want to 'dip their toe in the water' and develop experience with this model before committing to setting up their own captive, as captives should be viewed as a long-term commitment – once one is set up and capitalised, disbanding it can be costly and time-consuming," says Mr Latham.

AIG's Mr McHarg also notes growing interest in captive cell programmes as smaller and mid-sized companies seek to capitalise on the advantages that alternative risk management solutions can provide. "A captive cell programme is a relatively simple and inexpensive way for a company that is new to captives to gain experience and enjoy many of the benefits of retaining risk in a captive structure. Despite a relatively long history, the rent-a-captive market is still poised for growth – both for new regions and new types of companies in existing markets," he says.

Cell captives can be a useful tool in a hard market, according to Paul Wöhrmann, head of captive services EMEA, APAC and Latam at Zurich Insurance Group. "We are seeing growing interest from risk managers in forming captives or using virtual captives, such as protected cell companies. Some companies

"Where companies face a shortage of capacity or substantial retention levels, we see virtual captives being used to finance one or two short-tail lines of business"

that previously did not consider themselves to have the critical size to establish a captive are now finding this makes sense in a hard market. For example, where companies face a shortage of capacity or substantial retention levels, we see virtual captives being used to finance one or two short-tail lines of business," he says.

SRS Europe's Mr Bridgeman sees an increased utilisation of captive structures: "Captive owners are looking to understand whether it makes sense to expand the use of the captive to include more non-traditional risks. Quite often, and particularly where the capitalisation is determined using a risk-based approach, there can be a diversification benefit of combining uncorrelated lines of business within the captive structure. We are seeing more and more captives being used as the aggregator of risk to then facilitate structured reinsurance placements such as multi-line/year offerings. As the primary markets continue to contract, it is likely that groups will look to alternative commercial reinsurance and capital markets."

CAPTIVE FLEXIBILITY

The hard market means that inevitably the focus of captives will be on its traditional use, providing property and casualty insurance. This will aim to provide improved terms and conditions, provide cover where it has been excluded by the traditional insurance market, and achieve better value for money.

But captives have come a long way, and during the prolonged soft market they showed their worth in terms of providing a vehicle for alternative solutions, and in particular, providing ways to support a company's strategic objectives.

AXA XL's Mr Latham says that one of the fundamental appeals of captives is their flexibility. "The captive owner can structure and manage the captive based on the parent company's strategic objectives, risk appetites and the strength of its balance sheet. For some captive owners, the structure represents a cost-effective alternative to the traditional insurance markets; that business case is only strengthened when the markets harden.

"Other captive owners are interested in creating innovative structures to further enhance their ability to manage and mitigate unusual and/or challenging risks. Some of our captive clients, for instance, are using their captives to cover both stable, traditional risks along with less predictable, emerging risks," he says. "Where this happens, captives may want to consider how they protect their overall aggregate risk. In this case, the solution could be a multiline, multiyear programme supported by structured reinsurance. This type of solution enables the captive to mitigate the impact of unexpectedly large losses across a number of lines of business and/or in consecutive years."

This flexibility explains why captives have remained relevant throughout the underwriting cycle. "The past two decades have shown that captive formations occur during all phases of the insurance cycle and throughout varying economic climates," says Stephen Morton, head of multinational, Europe, AIG. "Traditional reasons – including a hardening commercial market – remain relevant drivers for captive formations. However, alternative risk transfer has developed into a longer-term strategy for sophisticated companies to leverage financial and coverage benefits over time."

He continues: "Existing captive owners are likely to expand the use of their captives during a hard insurance market, particularly for difficult-to-place coverages. But the benefits of self-insurance (including

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having greater control over risk financing and risk management, as well as customisation of loss control and claims mitigation strategies) remain relevant when prices soften again. The most successful insurance programmes maintain a balance of traditional and alternative risk transfer, with a strategy that adapts to changing market cycles."

Pierrick Livet, senior multinational client executive, UK, AIG, adds: "An accelerated move towards digital transformation, thereby impacting global supply chains, may cause organisations to rethink the insurance protections they have in place and expand the use of captives into strategic areas of their organisation. An added dimension is the changing risk landscape. As organisations grapple with emerging and intangible risks, such as cyber, reputation, supply chain and non-damage business interruption, the need for new and innovative risk transfer solutions has grown."

STRATEGIC BENEFITS

SRS Europe's Mr Bridgeman says that while traditionally captives have been utilised for property and casualty-type risks, in recent times they have been used for more innovative risks. "Similar to the way captives were used to incubate cyber risk until such time as the market properly understood it, the same is now happening for risks such as cryptocurrency and climate-related risks. The inclusion of these more non-traditional risks may act as a way for clients to diversify their captive programmes while at the same time optimising their overall insurance programmes," he says.

He adds: "Although the financial benefit of a captive is important, often the strategic benefits that can be derived are as important, if not more so. The ability to manage the volatility of smaller business units is a strategic benefit that a captive provides. Employee benefit risks being within a captive have trended upwards in recent years, however the primary driver here is not always financial. The ability to aggregate data and loss exposure to enable groups to better understand their risk and thus tailor programmes accordingly is key. Many captive owners continue to explore ways in which the captive could support and finance loss-prevention initiatives, together with health and wellness programmes."

One area that has long been talked about is captives looking to alternative capital solutions, directly accessing the capital markets for alternative and potentially cheaper coverage. Despite some heavy losses in catastrophe markets in recent years, investor appetite has continued and the hard market makes it more attractive to investors. And as the market hardens, corporates are becoming more interested in alternative options, including using a captive to access other markets.

"In current market conditions, there is a greater opportunity to explore the reinsurance and alternative capital markets and access capacity," says Zurich's Mr Wöhrmann. "We have seen a growing interest from risk managers with captives to start a dialogue with insurance-linked securities providers. We see more companies view their captives as a strategic vehicle to manage the insurance market cycle. Captives can be viewed as a strategic door opener to reinsurance and alternative capital markets when there is a shortage of capacity or an increase in rates."

"As organisations grapple with emerging and intangible risks, such as cyber... the need for new and innovative risk transfer solutions has grown"

The view from Europe

◇ ROUNDTABLE

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For this year's captive report, we wanted to explore the possibilities for captives in the third decade of the 21st century in the light of new risks and hardening markets, with captives taking on an expanding, strategic role, helping their organisations in their broadest aims. To do this, we invited a group of captive owners, managers and fronters to discuss the issues in a roundtable, hosted online by headline sponsor Zurich Insurance.

The participants were: Dr Paul Wöhrmann, head of captive services at Zurich Insurance; Andrew Bradley, retired former head of group risk services at Nestlé; Francoise Carli, Zakubo Consulting, and former vice-president, insurance at Sanofi; Daniele Zucchi, managing director of Sigurd Ruck, and chairman of the Swiss Insurance and Reinsurance Captives Association (SIRCA); Lorraine Stack, managing director of Marsh's captive solutions practice; and Dominik Ebneter, managing director, risk consulting and captive management, at Aon Switzerland. The roundtable was chaired by Tony Dowding, editor of Commercial Risk Online's *International Programme News*.

Tony Dowding: To begin, can we examine how a captive can help to 'close the gap', in terms of the risks faced by organisations and the insurance cover that is offered by the market, or the gap between primary and excess layers?

Paul Wöhrmann: As we all know, captives allow their owners to take a more flexible approach by obtaining access to other markets in order to optimise coverages. And recently we have seen with cyber, for example, that captives can help to develop coverage within insurance programmes, which is helpful both for subsidiaries and the parent company. It can help on the one hand to finance risks in order to protect the subsidiaries, and on the other to take risks into the captive and try to approach the reinsurance market and excess layers in order to follow arbitrage strategies.

We see captives as an important tool to help customers collect risk management information and provide a push within their own organisations to improve the quality of risk management. And when carriers are reluctant to waive exclusions in their terms, then the captive can finance them, provided that those risks are insurable risks that can be priced and where proper risk management can be delivered.

Across Europe, captives are taking on an expanding, strategic role

Daniele Zucchi: We at Sigurd Ruck have some first-hand examples of this 'closing the gap'. One example is the need of our group to have in place professional indemnity insurance that is linked to the fact that Saipem group sometimes acts as an engineering company while doing some construction and engineering works for the oil and gas business. Where there are projects financed through banks or public financing institutions, it is often a request in the contract that our parent company has professional indemnity insurance – a line of business that not everyone has available.

The captive in this case was useful in closing the gap between the risk management requirement and the insurance market. The insurance market didn't want to offer any coverage below a retention of €10m. So, we put the captive in that first layer and are able to provide certification to the client that the coverage is in place.

10 ➔

Another approach is one that we are currently dealing with – the renewal of the D&O programme for the group. We have written D&O for some years in the captive following our traditional approach, taking the first layers of risk in order for the insurers to be comfortable with the risk of the group.

However, this year it is proving to be quite a complicated year for the D&O renewal. There are no problems with renewing the first layer but the reinsurers of the excess layers, possibly above €100m, are extremely concerned about the effect of Covid-19 on D&O policies, despite a clean loss ratio. So, we have been asked by the broker that places that programme whether we would be able to close the gap in these excess layers using the captive.

The answer is, in principal, yes, but of course it depends on how much of the capacity will be missing on those layers. We have a limited capacity and we have to be careful because although it is two different placements, it is the same risk, so we have to make sure that we do not exceed that capacity that we place on this coverage in the light of the business plan that we have submitted to the regulator in Switzerland.

Andrew Bradley: An important issue in all this for reinsurance captives is whether you can find insurers prepared to front and, in these difficult times, at what cost? I am guessing this will be the key in the current market. You can underwrite all sorts of risks in your captive but are they material and financially worthwhile, bearing in mind whether the captive can underwrite the risk, does it have the capital to do so, impact on solvency, compliance, additional consultancy fees, licensing requirements etc? Hence, 'closing the gap' might not be that clear cut and at the end of the day, will the captive's contribution be material? If yes, all well and good, but it might not be the case for every situation.

Lorraine Stack said Marsh has been busy with a lot of interest in captives since the middle of 2019

TD: Does the hardening market, and in particular the growing exclusions and changes to terms and conditions, mean a greater role for the captive?

Lorraine Stack: I can give some context to the issue of the hardening market. The Marsh Global Insurance Market Index, which tracks commercial pricing increases, revealed that in the first quarter of 2020, prices globally increased 14%, the largest rise since the index was launched in 2012 – and that is before any real impact from Covid-19 claims activity. It is the tenth consecutive quarter of price increases. The averages globally were 15% for property, 26% for financial and professional lines, and 5% for casualty.

Marsh manages about 1,400 captives globally and we looked at the claims activity in the first quarter, right at the start of Covid-19 situation, and we found the total incurred losses across the entirety of our book were up 8% over the prior year. Auto and GL were both down, not unexpectedly with the restrictions on commercial activity, but for business interruption, travel and to a lesser extent EB life, loss activity was up 120%. And we expect to see a lot more, especially in business interruption. D&O is a very distressed line and we have a number of captives writing D&O, and expect to see growth here given difficulties with capacity constraints.

As we know, captive formations tend to increase during hard market cycles and we have been busy with a lot of interest in captives since the middle of 2019, in terms of feasibility studies and implementations. This is being driven by increased pricing, lack of capacity, especially in D&O, lack of fronting, and the growing number of exclusions and changes to terms and conditions.

Also, a lot of multinational EB programmes have been discovering during the last few weeks just how inconsistent their programmes are globally in terms of coverage, and at least those with captives have the ability to potentially use them to close that gap.

This is where captive value is at its best – with skin in the game, you have something to negotiate with, and potentially mitigate the impact, offer some capacity and provide coverage that is not available, or not economically viable in the market.

TD: Does a hardening market make it easier to justify the captive's place in the company, and give it a higher profile and therefore able to take a more strategic role?

Andrew Bradley: Does it make it easier? I would suggest that in any case a captive should be a strategic cornerstone of your risk financing

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strategy, regardless of whether it is a hard or soft market, and hopefully people would take a long-term view and not go in and out of the marketplace, but that will depend on the philosophy of the company that you work for. It should, in my view, also be a cornerstone of loss prevention because with the data and claims that you obtain, you should be able to positively influence the loss prevention in your company.

I also think we should be looking at sustainability, and particularly the UN sustainability goals, and try to link what we do in the insurance industry and in captives to these goals. This would help give more credibility and relevance to what we do and help position the captive in a more strategic role, rather than just a last resort because the market is hardening.

Francoise Carli: When the market is hardening, this is a signal that risk managers can use to better sell the use of captives in their setup. I have seen a couple of companies that I worked with struggle in the last few years to increase the captive's role in the company because the market had capacity and appetite for new risks, but this is not true anymore. So, putting new programmes in their captive in order to show insurers that they have trust in their risks and in the way they manage those risks and support their business, is a fantastic opportunity for risk managers when there is a hardening market.

It is not necessarily going to generate a financial benefit – the difference in price is not as big as it could have been in the past, but it is a step in. Once you have your property programme in your captive, I don't think you will withdraw this programme from the captive in the next ten years – you will just benefit from the market and the situation to increase capacities or guarantees and to get rid of certain exclusions, etc. The hardening market is a fantastic opportunity, not only for risk managers without captives but also for those that have captives that have not been a significant tool yet.

TD: Is the captive an appropriate vehicle to 'incubate' emerging/uninsurable risks?

Dominik Ebneter: Yes, but it depends. It is important to bear in mind that captives are regulated insurance companies and therefore have to comply with certain standards. They need to be sufficiently capitalised and maintain solvency ratios in line with the risk they are underwriting. So ultimately, the company's capital is what defines the underwriting capacity and hence the captive's ability or its flexibility to underwrite additional risks.

A captive has to follow certain underwriting principles and requires a clear definition of the new emerging risk, clearly describing what the loss event is, what is triggering it and most importantly, it needs to be quantified, or have the ability to quantify the risk in order to define if the capital is sufficient, and that the captive can take on the emerging risk. The company needs to understand the maximum possible loss scenarios and occurrence probabilities of such a new risk. So, there are limitations and issues to overcome, as there are for the insurance market.

Dominik Ebneter said it can definitely be a benefit for the company to expose the captive to new risks

But of course, from a captive owner point of view, if you have an exposure to a particular risk, then you have it on your balance sheet anyway, and instead of taking the hit on the company's balance sheet if the event materialises, with a captive you may have the opportunity to build up fluctuation reserves and IBNR reserves and premium income, which can help to finance the new risk over time, so it can definitely be a benefit for the company to expose the captive to such new risks.

Francoise Carli: I really think that a captive can be an incubator. It means that you start small, you get bigger, you develop and multiply. It certainly depends on which industry you are in – life sciences or hi-tech industries have unique type of risks and very creative and innovative projects, but none of the insurers are ready to share that at early stage. So, if you don't have a captive tool that allows you to collect data on what can happen, how much it could cost, how difficult it could be to mitigate, then there is no way it can become an insurable risk or at least a manageable risk in the coming years.

I think that in certain industries the captive is much more than a risk management tool. It is a business tool. If you can use it as such, then the question of knowing whether the captive is tax-efficient or financially beneficial for the company becomes completely different. The question is more: how do you allocate the financial budget for risk issues for the captive? Do you allocate more to product liability, or D&O, because there are issues in those lines in the market due to price or capacity, or do you use it for a new product where no one knows exactly how it is going to evolve but where you have to take on the risk?

Daniele Zucchi: It think it depends on what kind of captive organisation you have in place. If you are a direct captive, then it can easily be an incubator. It might be more difficult as a reinsurance captive because you still need a fronter. For uninsurable risks, it might not be easy to find a

fronter even if you ask them to front 100% of the risk. We have seen this in the past with professional indemnity and I am sure we will face the same issue in the future. I would love to use the captive as an incubator rather than just for traditional property/casualty lines but it depends on many factors and the industry sector you are in.

TD: Is there an opportunity now for captives to take a much more strategic role in their organisations? Not simply in terms of risk financing, but in terms of the broader objectives of the business?

Andrew Bradley: I have always felt that the captive should be a strategic vehicle in all times, good and bad. And you should always align the captive's objectives to the main group's objectives – you have to make a link between the two otherwise you are going to have a very difficult time trying to sell the captive's value to your management.

It is not just about taking the risk but also the whole loss-prevention element – how you can improve the risk over a period of time. I would suggest taking profits out of the captive to help pay for loss prevention, not the capital expenditure on sprinklers etc, but developing cost-effective programmes that can influence loss reduction. We used to try and implement loss-prevention programmes for each line of business, including employee benefits, to make it truly a strategic tool.

Other areas might include looking at some of the UN sustainability goals – is there something there that can be picked up and sold to your management? We put motor vehicles through the captive and not only did it make an underwriting profit, but over a ten-year period, losses reduced by implementing a loss-prevention programme.

We also looked at microinsurance to help coffee growers. It very much depends on the licence that you have for your captive as to what you are able to do. We even did a pet insurance programme for the US – a great strategic move as we were selling cat and dog food to the US. It is about finding something that links back into the business, which can make the captive a strategic tool.

Lorraine Stack: We are certainly seeing an increase in third-party business being written in captives, including warranty, customer business and affinity lines. We are also seeing more and more captives using surplus to fund risk management projects, including loss prevention programmes and the funding of wellness programmes – it can be hard to get a budget for these sorts of programmes. If you have a mature captive, then is likely that you have surplus and therefore the ability to fund these types of things.

More and more captives are using surplus to fund other projects, including wellness programmes

Dominik Ebneter: At the end of the day, the captive is a strategic risk financing tool; it is about financing the company's risks in the most efficient way from a total-cost-of-risk point of view. But from a holistic risk management point of view, risk financing comes into play if other measures have failed, if a loss event has happened and could not be prevented. So the crucial thing is to work hand in hand with loss control measures, with operational risk management and health and safety experts within the company, to find ways to change the current risk profile of the company in a positive way to bring the number and severity of losses down, which will improve the risk financing side. By participating in this, the captive will benefit from the improved risk profile achieved by appropriate investments in risk control measures.

Paul Wöhrmann: For me, it is about strengthening the core business, and how a captive can help with this through finding solutions, so it is looked at more as an investment, not only as cost optimisation. Companies with captives have much greater flexibility these days than those that are limited to the choices provided by the insurance markets.

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Francoise Carli: Captives have flexibility but they have been helped by insurers, who have become chilly and fearful. Sometimes I wonder why insurers say they are risk owners, because they are new or large risk averse, they are risk fearful. Which means that if nobody is taking the risk then somebody has to do it – and that is the business!

Paul Wöhrmann: From the customer point of view, with all the mergers that have happened, could their choice of large international insurance companies be reduced over time? And as a result, could a new strategic role for captives arise, in which they look at the insurer more as a service provider, with the captive having a more active role in the risk-transfer piece?

Lorraine Stack: That is great as a vision for the future, and there are a number of multinationals out there that are operating in exactly this way and have been for a while, and now the hard market and the lack of options will force more companies to start morphing into this structure.

Francoise Carli: Yes, this could be the future, but there are two main constraints. The first is that the customer, the captive owner, must have the captive mindset embedded in their vision. This is not for someone who created the captive two years ago, but where the captive has been running for the last 15, 20 years – you need some history and sustainable practices.

The second constraint is linked to the servicing pricing. Current insurers taking this new role would have to significantly explain how they price their servicing. If not, it is just a hidden transfer of fees for a quality, efficiency and outcome that may not be exactly what the customer is expecting. This will require the same approach for insurers as the one customers are asking of their brokers, where they want more transparency.

TD: How much flexibility is there in captive pricing to actually be able to use it as a risk management tool for rewarding/penalising good risk management practices in subsidiaries?

Andrew Bradley: In theory, you should be charging businesses/sites with a poor risk profile more premium or perhaps applying higher deductibles. However, the reality might be different when you take into account BEPS, local market conditions, transfer and arm's-length pricing, as well as what control you have over the local subsidiaries.

In my old company, we had a large property programme, hence the premiums per factory were very low compared to the total budget of the site, but people still felt (doesn't everyone?) that insurance premiums were too high and tried to argue that because they had done x or y, their premium should be lower, even when the allocation was rock bottom (for example, this particular site was paying more than twice as much in cleaning costs as it was paying in insurance premiums).

It is also a question of education, as premiums have become so low in recent years that there is often little or no room to reduce further, hence the main reason should be that loss-prevention investments etc protect people and assets and enable the business to continue. At the end of the day, there is only one group balance sheet and that's what needs to be protected.

If you are not careful, you can create a very complex allocation structure that is subject to continual debate and slows down the whole risk management process.

Obviously, if you have a line of business that is not working properly, for example a motor or workers' compensation programme, you need to look at premiums, but the fundamental should be looking at the underlying issue and implementing the appropriate loss-prevention programme.

Francoise Carli: It has worked for various of the companies I worked with and for. I was able to organise a sort of premium refund for good technical results on the property programme, but you have to figure out how you are going to use it. There are things that you can do in terms of rewarding or penalising risk management practices but it has to be clearly focused, because you have very little money to invest and the reward has to be used properly.

Paul Wöhrmann asked whether a new strategic role for captives could emerge due to reduced customer choice following recent large insurer M&A deals

TD: It is often said that one key benefit of a captive is access to reinsurance markets. How accessible is the reinsurance market to captives and do many captives take advantage of this?

Dominik Ebneter: It very much depends on the maturity of the

captive, its solvency, its reputation in the market, perhaps a rating. Reinsurers are concerned about how their counterparties are managed. If a well-managed captive approaches the reinsurance market, then there is definitely a lot of opportunity and flexibility that can be achieved.

If you need to place risk in the local market on a direct basis, you have less choice and flexibility, whereas on the reinsurance side the choice is much bigger – you can go abroad, to different markets, to place the risk for the most attractive conditions.

Daniele Zucchi: Our experience is that for us it is quite easy to access the reinsurance market and easy to purchase insurance when needed, because reinsurers perceive our capacity to control the risks that we write into the captive, and they appreciate the amount of data and statistics that we can provide for them. It is important for them to have this data because each and every captive is different. Risks are different from captive to captive and the way that the information is collated and provided to the reinsurance market is important, together with the confidence that you have in your risks and the data. Captives undoubtedly facilitate access to the reinsurance market.

Paul Wöhrmann: The reinsurance market is specialised and experienced in providing high-excess coverages. If they are interested in getting down to volatile risks in order to diversify their portfolio, they have two strategic choices. They can buy insurance companies, or they can try to get access to the retrocessions from larger captives and try to develop their portfolio this way.

TD: On the regulatory/tax side, are there any threats or concerns on the horizon that captive owners need to be aware of?

Lorraine Stack: There are no potential existential threats to captives but there is a lot of noise out there. The most imminent is the EU Mandatory Disclosure Regime (MDR), known as DAC6, which requires disclosure to tax authorities of potential aggressive cross-border tax arrangements that meet some predefined hallmarks. Also, in February the OECD released transfer pricing guidelines around BEPS that will require some rigour around certain activities, including pricing calculations.

IFRS17, although delayed a little, is a new accounting standard for insurance and reinsurance contracts, now coming into play in 2023. It might not be applicable in local domiciles, which might report in local GAAP, but if the parent group is subject to IFRS accounting standards there could be some additional work required at consolidation.

If the parent group is subject to IFRS accounting standards there could be some additional work required at consolidation

Across all of these is this common theme and perpetual challenge that we as an industry need to constantly explain the captive and validate its value as a risk management tool rather than as a tax-avoidance tool, which it clearly isn't. The current hard market conditions will help no doubt in underscoring that value.

Paul Wöhrmann: An initial observation from me is around BEPS and the issue of onshoring versus offshoring. Many years ago, offshore captives were common, but now captive owners are looking to bring their captive back to their home country. My interpretation with regard to BEPS is that they would like to concentrate enterprise risk management with insurance management of the captive, to have it under the same roof in the home office in the parent's country.

Dominik Ebneter: In the past couple of years, there has been some consolidation taking place, with companies that have various captives in different domiciles, driven by BEPS and the fact that with soft market conditions until recently, underwriting profits were not so substantial as before, finding it harder to justify the cost of multiple captives. Redomiciliation of captives from offshore domiciles to onshore sites closer to their main operation and head offices is clearly something

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that we have experienced recently. With the hardening market, I don't think this will change anything and I don't see companies establishing different captives in different domiciles to a large extent, as this was the case in the past.

Lorraine Stack: We are hearing that some companies, particularly French and German, are looking to move their captives onshore to the home country of the parent. The theory behind it makes sense, especially if it can avoid all challenges from local fiscal authorities. But it throws up issues on the administrative side in trying to deal with insurance regulators. In those jurisdictions, such as France and Germany for example, housing a captive can be quite difficult because the regulators do not apply proportionality. So, while the tax authorities may leave you alone, you have a whole set of additional problems.

Francoise Carli: For a long, long time, before solvency, captives were a 'money pocket'. With the potential recession we are likely to see around the planet, we are going to see claims in those captives, and when you have claims, the 'money pocket' idea is no longer valid. It becomes a real insurance or reinsurance company. Solvency II brought in all the mechanisms to manage a captive the right way and this is now playing its role. The existence of claims takes the whole tax issue far away from the table.

In addition, if the risk manager really wants to run a captive, they must dedicate time to it. Because it takes time, capabilities, competencies and it takes really a lot of effort to make it work. As an example, in many large groups, the tax and accounting people have no idea how they would integrate the work that is done by captive managers internally. Indeed, one advantage of domiciles is that you have the choice of available specialists. This is why, the thought of having captives in France makes me laugh sometimes, because there is no local specialist to manage captives, while there are loads of them in Switzerland, or Ireland or Vermont.

TD: Finally, how is technology being used to improve the captive's functions and drive efficiencies?

Paul Wöhrmann: Everyone is looking to try and increase efficiency. Information is key and needs to be provided in a fast, transparent and complete manner. Efficiency can be increased in international programmes when closer collaboration can be achieved between the company insured and the fronting insurer. There is a real chance to achieve this by implementing API connectivities between the company insured, the fronting insurers and their network. More information can be collected, and with better information they can drive arbitrage strategies and negotiate better terms and conditions with their insurance and reinsurance partners.

Daniele Zucchi feels that everyone is waiting for someone else to make the first move when it comes to new technologies

Daniele Zucchi: I feel that everyone is waiting for someone else to make the first move when it comes to new technologies and applying them to global programmes, but no one is making that move. It would be fantastic to have a system where I know in real time that the local policy has been issued, the local invoice has been issued, my local colleague has received it, and the movement of the money. This would solve a good percentage of the daily problems in the management of captives. Is the reason why the technology is not yet there because the reward is not enough for the investment in such systems?

Andrew Bradley: As an industry we have been slow to embrace technology, but it has to come in order to drive efficiency, reduce errors and costs… and do away with the Excel spreadsheets.

We had a large book of business with Zurich and worked with them over a number of years to develop an API system – it made perfect sense and reduced duplication, improved efficiency etc. We started with property/casualty then added loss prevention and subsequently included employee benefits.

It worked for us and we were pleased with the results. But as most companies are using several insurers, trying to implement this approach over your whole book of business could be a challenge.

A thought…why should each major insurer have to develop its own system? If we look at oil, gas, railways, telecommunications, there is often only one platform – could this be an option for our industry? A standard, independent platform that insurers could plug into to drive down costs etc? Too optimistic perhaps?

Centre of the world

◇ PROGRAMMES

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Global insurance programmes are notoriously time-consuming, complex and often unwieldy. But having a captive at the centre of such programmes brings many benefits. Captives have two very clear advantages when it comes to global programmes. Firstly, they can provide a central focal point for the programme; and secondly, the captive offers flexibility as risk financing tool.

A captive provides access to the reinsurance market, and a focal point for premium allocation. It also allows for flexibility when it comes to the setting of retentions locally. All of which are crucial issues for the smooth and efficient running of a global insurance programme.

Stephen Morton, head of multinational, Europe, AIG, explains: "Despite an overall decline in the number of captives worldwide, we have been seeing an increase in the use of existing captives. We have seen the captive fronting business continue to grow as companies expand the use of existing captives to encompass additional geographies and lines of business. One reason for this is the ability of a captive to help centralise and optimise a company's insurance programme in managing global risks. A global fronting programme can streamline the efficiency of a complex multinational programme by allowing the client to retain some of the risk."

Having a captive at the centre of global programmes brings many benefits

Derek Bridgeman, managing director, Strategic Risk Solutions (Europe), says they are certainly seeing the captive becoming more central to the overall insurance programmes. "Sophisticated risk managers really value the flexibility that the captive can provide them, where the market is unwilling to provide the insurance or unwilling to provide it at an efficient price, then the captive can be used as an alternative. By placing the captive at the centre of the risk

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Collaboration: The key to navigating a hard market

Dan Sammons

Stephen Morton

A hard market calls for an alignment of interests and closer collaboration between insurers, service providers and clients, explain Dan Sammons and Stephen Morton

A hard insurance market has traditionally been a bellwether for captive growth. Previous hard markets have seen existing captive owners make more use of their risk retention vehicles while also driving the formation of new captive solutions. This hard market is likely to be no different.

The challenge for insurance buyers and captive owners is how to best manage increased deductibles/greater risk retentions, while also softening the blow of increased re/insurance premiums.

A PERFECT STORM

There is presently much talk of a 'perfect storm' in the commercial insurance market. After a prolonged soft market, prices have been rising in the past two years. This is a result of increased losses, reduction in capacity (particularly in distressed classes), market performance reviews, adverse loss reserve development and lastly, uncertainty surrounding the global pandemic and its impact on claims.

According to Marsh[1], global commercial insurance premiums increased by 19% in the second quarter of 2020, with significant price hikes in US public D&O (up 59% on average) and UK D&O (up 100%) driving rates up by 37% globally across financial and professional lines. Geographically, composite pricing increased in all geographic regions for the seventh consecutive quarter, led by the UK (30.5%) and the Pacific (31%).

Meanwhile, the long-lasting low interest rate environment has meant that insurance companies have, for a long time, been unable to prop up a disappointing underwriting result with investment returns. This is exerting yet more pressure on underwriters to charge more and increase deductibles – the point at which insurance attaches – a situation that is unlikely to change as we enter another global economic downturn.

In addition to pricing, insurance companies are incorporating tighter terms and conditions. The upshot is that conditions have become more challenging for insurance buyers, not least because their premiums are increasing and at the same time they are forced to retain more of the risk within their captives or on their own balance sheets.

An added dimension is the changing risk landscape. As organisations grapple with emerging and intangible risks, such as cyber, reputation, supply chain and non-damage business interruption, the need for new and innovative risk transfer solutions has grown. Within AIG, we are seeing an increase in interest in alternative risk solutions as commercial insurance has become more expensive and capacity is harder to find.

LESS CAPACITY FOR CROSS-CLASS PLACEMENTS

There is no one-size-fits-all solution. Different clients will have different needs and the onus is on all parties, including captive managers, fronting insurers, brokers and risk and insurance managers to sit down and talk through the available solutions. This can include a number of creative and innovative options, such as alternative risk solutions and joint, scalable captive solutions, such as a multi-captive 'mutual' approach.

Single-captive stop-loss covers are becoming more challenging to place as there is a limited market for multiline products. While they are beneficial programme placements from a captive perspective, it is not always possible to enter into long-term agreements on cross-class aggregates when the market is hardening. Hence, a more traditional approach may be required, with separate towers for different classes of business.

The value to clients of a traditional approach to self-insurance is that they can widen their universe of potential re/insurance carriers, without necessarily paying a great deal more in premium. There is also the option to invite more reinsurers to the table if each line of business has its own stop-loss policy. This way, the whole market can be involved and insurance buyers can be sure they are getting a more competitive placement.

Insurers can also benefit from clearer insight into their maximum losses when taking a line-by-line approach to insurance. For clients concerned about the impact of higher deductibles and how this may cause greater volatility on their balance sheets, brokers, insurers and captive managers are working together to offer innovative solutions. Loss portfolio transfer, for instance, can spread the cost of a severe claims year over, say, three to five years, offering capital relief and smoothing out the impact of a loss.

In this challenging environment, there has never been a greater need for collaboration to develop solutions for insurance buyers and captive owners. The hardening trends are unlikely to reverse anytime soon. Even when capacity returns and premium rates decrease, alternative risk solutions can continue to offer value and complement traditional insurance placements. What is clear from the many discussions around this topic today is that the solutions implemented today will continue to play a large part in our clients' long-term risk management strategies.

For insurers and service providers, this hard market provides an opportunity to differentiate and engage meaningfully with our clients towards managing global risks. It is about ensuring there is an alignment of interests and that we are ultimately arriving at the best solution for all parties. All parties collaborating towards the same goal builds trust, understanding and, inevitably, value.

Dan Sammons is head of global risk solutions at AIG UK and Stephen Morton is head of multinational, Europe, AIG.

1. www.marsh.com/uk/insights/research/global-insurance-market-index-q2-2020.html

management process, there is the ability to oversee, control and better influence the group's approach to risk and insurance."

CENTRAL ROLE

Captive experts are clear that a captive should be right at the centre of a group's global programme. "The captive should be central because it should be part of the strategy when you start your global insurance programme, asking: What is the role that you are going to take and what is the role that you are going to leave to the insurers?" says Francoise Carli, Zakubo Consulting, and former vice-president, insurance, at Sanofi. "If you think the insurers are the ones that are supposed to bear the risks, then it is a completely different situation. But if you think the insurers are bringing you capacity and you are the one managing the risk, then there is no way that the captive is not going to be in the centre."

Lorraine Stack, managing director of Marsh's captive solutions practice, agrees: "Most of the larger captives that we manage are doing just this; the captive is at the core of the risk management philosophy. For instance on property, where you have a captive that has the ability to direct write wherever it can, and is then reinsuring where the captive cannot provide direct policies. So the captive is precisely at the core of that global programme. We are seeing signs that maybe D&O could start morphing this way, certainly in the near term, to help address the issues that are happening there. Employee benefits, when it works, puts the captive right at the centre of this. And where the captive is closing the gaps, getting more access to external market capacity, for the catastrophe risk."

A captive is a very effective risk financing tool to protect business units while also leveraging the organisation's overall ability to retain risk, according to SRS Europe's Mr Bridgeman. "Extending this concept across international borders, where local regulations may limit insurance and reinsurance

> "As coverage becomes more expensive in the traditional market, one of the greatest advantages of a captive is the ability to craft bespoke terms and conditions at a lower rate"

options, makes the captive an even more valuable tool. In the current market, using a captive in this way needs to be weighed against other potential uses, such as participating in professional indemnity or D&O lines. With limited capital, a captive may need to pick and choose where it can add the most value," he says.

According to Matthew Latham, CUO, global programmes and captives at AXA XL, one of the most important benefits of a captive to a multinational company is that it allows the company to retain risk at a group level that is commensurate with the strength of the organisation's balance sheet. "Having local policies, which are part of an overall global programme, allows retentions to be set appropriately at local levels, but then the captive, through the reinsurance arrangements it has with fronting insurers like AXA XL, can retain risk at a level that is appropriate for the parent company. That is where captives really show their benefit," he says.

PROGRAMME FLEXIBILITY

Again and again, the flexibility of the captive is highlighted in its role in a global programme. "As coverage becomes more expensive in the traditional market, one of the greatest advantages of forming a captive is the ability to craft bespoke terms and conditions at a lower rate," says Pierrick Livet, senior multinational client executive, UK, AIG. "Quality of coverage doesn't have to be sacrificed in order to protect the bottom line. This programme flexibility granted by a captive is often one of its greatest benefits, as the traditional market offerings may not provide sufficient capacity or coverage terms. A captive can step in to cover these gaps, and the owner can then choose to retain those risks or directly access the reinsurance market."

He adds: "For many companies, using a captive to help manage a global programme is a way to centralise and optimise a multinational insurance programme's span and meaningfully manage global risk."

Why now is the perfect time to onboard EB to your captive

◇ EB TRENDS

Ludovic Bayard, Generali Employee Benefit Network

Talent risk has been catapulted from 11th place, in January of this year, to the number one spot right now in terms of threats to long-term growth, according to global CEOs.[1]

It stands to reason then that talent risk should also now be reflected in the top risk managers' concerns. While independent survey data in that regard has yet to catch up, what we do know for sure is that the ever-hardening market is leading more risk managers to consider the use of captives. In 2018, 15% of respondents were considering using captives. Now, 43% are considering this solution.[2]

Ludovic Bayard

In short, the argument for supporting employee health and wellbeing via growth in employee benefit captives is stronger than ever, and never more so than where an existing captive exists.

Even where a captive is currently non-life only, there is enough global evidence now to help instil trust in non-life risk and captive managers that the captive will not only deliver cost containment of overall employee benefit spend and deliver all-important diversification, but also allow for many non-financial advantages.

These include, for example, flexible underwriting and benefit design, plus the ability to introduce essential benefits for all, such as telemedicine, to help support employee wellbeing during remote working and return to workplaces. And, underpinning all of this, data to help inform customers on their local risk profiles, supporting strategies to reduce claims costs and roll out tailor-made prevention initiatives.

We spoke recently with some of our employee benefit captive clients, as part of GEB's Network Partner Conference, to learn about their experiences during the year so far.

BENEFITS DELIVERY

Everyone agreed that in the face of all the increased demands on the workforce to deliver – especially during lockdown – the ability to deliver much-needed benefits represented a real bonus. For some captive clients, this included our support to help them introduce telemedicine.

For others, it involved help to ensure consistency of certain coverages. In some cases, pricing was getting very high on certain types of coverage, in certain jurisdictions. GEB was able to help with the underwriting, specifically around life insurance, to make sure clients didn't face any unpleasant surprises with regards to coverage.

CONTINUITY AND CONSISTENCY

Kelvin Wu, general manager, risk management and insurance, at health and security services company International SOS, added that the nature of the company meant that they were not only continuing to operate 24/7 on a global basis but they also had to "ramp up the activity, to deliver additional services to clients in terms of assistance, evacuation and repatriation".

From a HR and employee benefits perspective, this meant that compliance with changing local regulations was essential, plus ensuring that employees didn't face any interruption in cover, considering they were continuing to work through this period to support clients.

"This is where having an employee benefit captive programme – ours being well established now for a number of years – definitely helped. We had to quite quickly go through the process of mapping the scope of benefits, ensuring consistency and identifying whether there were any jurisdictions with pandemic exclusions. In such circumstances, the captive could step in to make sure there was consistency in coverage."

PARTNERSHIP WORKING

Alan Halsall, global benefits manager for international recruitment company Randstad, said the pandemic has accelerated closer working relationships with their operating companies, "which is good for the buy-in and also there's a greater focus on cost savings", adding: "And during a hardening of markets, a captive is useful in that regard."

In his opinion, there are three essential considerations when looking at whether to bring onboard a new local employee benefit plan.

"We look at whether there's going to be collaboration between ourselves and the local opco, as we require them to make a long-term commitment to the captive. Secondly, from a network perspective, we need robust claims data so we can understand our risk profile. Finally, for reinsurance purposes we also need to identify whether there are any high individual sums assured, because that needs to go in and we transfer that risk to another party."

DUTY OF CARE

Mr Halsall, Mr Wu and other captive managers agreed that employees will have much greater expectations post-pandemic (if such a time exists), with regards to employer duty of care and, as part of that, benefit design, service and flexibility.

In order to square the circle of delivering against those expectations – to support employee retention and motivation – while also containing costs, an employee benefit captive is, quite simply, unparalleled. All it takes now is trust.

1 KPMG, Global CEO Outlook, Aug 2020, https://home.kpmg/xx/en/home/insights/2020/08/global-ceo-outlook-2020.html

2 FERMA, The risk manager facing hardening insurance market conditions, June 2020 https://www.ferma.eu/app/uploads/2020/07/The-European-Risk-Manager-Report-2020_29.06_final-insurance.pdf

Taking a collaborative approach

◇ BENEFITS

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Employee benefits within captives has been talked about for many years, in terms of the potential and the benefits, but the numbers have always remained low. However, the numbers are increasing and there is now much greater interest in the area. Marsh, the largest captive manager in the world, notes in its *2020 Captive Landscape Report: Captives Offer Value in Uncertain Times* that during the past five years, the number of Marsh-managed captives writing medical stop-loss coverage has increased by 50%.

The report states: "The use of captives to fund employee programmes continues to increase. International benefits and programmes for non-US employees have grown steadily for many years. In the past, a key factor in adding benefits to a captive was an owner's desire to achieve cost savings. While that remains an advantage, employers' main reason to write benefits through captives has shifted. Now, multinational companies especially are looking to create customised and consistent benefit programmes that enhance the value proposition for current and prospective employees."

SILO-BASED ORGANISATIONS

When it comes to employee benefits and captives, part of the problem with translating the interest into action is that many organisations are still too silo-based. As Damian Ross, regional manager UK, Ireland and Nordics, Generali Employee Benefits (GEB) Network, points out, there are some 7000 captives worldwide but only about 100 employee benefit captives.

"There's a need for further experience sharing in line with the amount of control and cost savings a captive affords. Often, employee benefits are not part of the corporate risk management framework. This is because risk managers are not so familiar with employee benefits and HR managers don't get to know how to manage people risks. It's important for risk and HR management to look at things much more holistically," says Mr Ross.

"That said, the situation is improving. We're seeing interest from risk managers. They're looking at employee benefits, realising the risks and looking at where their skills can help with regards to controlling costs. GEB takes part in the annual Airmic conference – an association for those with responsibility for risk management and insurance – and it's safe to say that ten years ago there was very little interest in our session on EB captives, with only some people attending. At the last event, the room was absolutely packed," he says.

The use of captives to fund employee programmes continues to increase

Daniele Zucchi, managing director of Sigurd Ruck, and chairman of the Swiss Insurance and Reinsurance Captives Association says: "Part of the problem in dealing with HR, and they would probably say the same about dealing with insurance/finance, is that the two departments are extremely silo-organised. There are not many groups where there is a clear route of communication between them."

Such a situation is not conducive to collaboration but this needs to change, says Ricardo Almeida, head of business development, MAXIS GBN: "It's no longer possible for employee

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benefits captives to succeed if working in silos. Compensation and benefits and risk management departments need to work together to manage expenses and align with global and local procurement. There must also be close collaboration with other key corporate functions such as HR, tax and legal to hit the company's risk management and HR goals."

Reto Heini, global employee benefits solutions, Zurich Insurance, agrees: "I never really understood why employee benefits was not part of a company's overall risk management strategy, though I think maybe limitations on things like data availability and fronting networks could be responsible. The market now though has really moved on, and it makes sense for risk managers to consider inclusion and at the same time get access to the data. With medical insurance in particular, captives can play an important role in reducing long-term costs by helping to manage the portfolios actively to minimise claims and limit medical inflation."

He adds: "Once the data is available for analysis, part of our job at Zurich is to help work with the captive to control costs and then identify wellbeing strategies that can be rolled out locally and globally to tackle health issues within the workforce. Local HR colleagues will normally be very happy for this type of assistance as they may have limited experience in analysing things in this way. Linking the risk managers and HR functions together to tackle these issues moves the company away from some of the older silo-based thinking, which is in part why employee benefits is lagging behind in terms of use within captives. The good news is that the insurance networks and consultancies are already working together to help close these gaps."

CLOSER COLLABORATION

The whole issue of collaborating successfully with HR has been going on for years and is very difficult to manage, according to Andrew Bradley, retired former head of group risk services at Nestlé.

"It's often made more difficult because most benefits programmes are arranged in a very decentralised way, with benefits set locally, often with no standard approach. But if you go the captive route, the things you find out are incredible – the limits and covers that are provided in some countries, and companies within the same country being very different, not to mention the size of consultancy and broker fees. If you open the pandora's box, you will find direct or indirect savings. It certainly makes a fabulous diversification for the captive. But building a collaborative platform between HR and insurance/risk management to move this topic forward is the challenge. We've been talking about this for 15 years and no one seems to have the answer to it," he says.

Cooperation is without a doubt essential to the success of a captive, says Mr Ross. "One of the main hurdles to overcome is ensuring that HR and the risk manager talk. Without that conversation, neither party will understand the shared advantages of putting in place a captive arrangement. For companies that have implemented a captive programme with HR

Generali's Damian Ross says One of the main hurdles to overcome is ensuring that HR and the risk manager talk

and risk management buy-in, the advantages are clear – with the smoothing of local costs in hard and soft markets making budgeting easier, the potential payment of grey area claims, and enhanced management information, to name but a few."

But it is not just HR failing to engage. Risk management needs to take the lead on the issue. "When I talk to new companies, the main problem is often that risk management does not even reach out to HR to talk about captives," says Mr Heini. "Any company wanting to implement an employee benefits programme needs to make sure these two important stakeholders are in touch with each other, and normally we find it is the risk management team that takes the initiative."

He continues: "Once HR realises the potential advantages that use of a captive can give them and understand they will not be losing control of the schemes themselves, they will be active supporters of the programme. The most successful and fastest-growing employee benefits captive programmes I have seen were generally initiated by the non-life side of the company and grew with the full support of the HR teams. Of the entire Zurich employee benefits captive portfolio, just a couple were actually initiated specifically by the EB side with no prior non-life involvement. So, any risk managers wanting to go in this direction will need to take the lead."

WHO DOES WHAT?

In terms of the different roles in the situation where a captive is writing EB, Mr Ross says that under a typical captive scenario, HR is in control of the level and type of benefits required in order to remain an attractive employer in their local markets.

"They're also the people who will understand whether benefits are in line with company policy. In short, HR holds the governance

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piece, while the captive and risk manager (with the advice of the network) set the price on a local basis. Risk management can support HR and local subsidiaries with regards to increase of service deliveries or non-traditional benefits in markets, where legally feasible (eg gender dysphoria)," he says.

He stresses that there are many crossovers between HR and risk imperatives: "The key is to encourage both parties to discuss the upsides and downsides of actions. For example, risk might say that deductibles on a medical plan make sense to help reduce claims. In order to encourage HR to action this, risk needs to help HR understand how such a move on a local level will potentially reduce costs. HR has to consider the impact on employees too, in providing a competitive package in the local market."

MAXIS GBN's Mr Almeida sees three 'megatrends' that are driving a more holistic approach to employee benefits. Firstly, HR and compensation and benefits are becoming more centralised functions, and one of the greatest advantages of using a captive is the enhanced governance and the reduction of corporate HR time and costs, especially when it comes to managing renewals and re-marketing of local cases, he says.

Secondly, the continuing rise in healthcare costs and lifestyle/chronic diseases creates an additional opportunity for captive managers by including healthcare benefits in captives, he explains. "The primary goal is to curb rising medical inflation with benefits design changes and wellness programmes to improve the health, productivity and engagement of the company's employees," he says.

And finally, he is seeing captives obtain better control of their compensation and benefits through digital advancements: better data for the captive and HR functions gives multinationals a deeper insight into their benefits and cost drivers, leading to a more unified approach to underwriting and managing employee benefits.

COMPANY PHILOSOPHY

Much of the success around captives being involved in EB depends on the philosophy of the company. "If the company is strongly centralised, then it obviously makes sense to centralise the benefits programme while keeping it local at the same time," says GEB's Mr Ross. "However, this only works where there is strong central control in place or ideally a central mandate to say that employee benefits business has to be placed in the captive. A lot of companies don't have this central control. Consequently, the captive can end up competing in local markets, leading to unsustainable pricing or business not being placed in the captive. Central control can help with all of this; for example, smoothing pricing and allowing certain exclusions to be removed. We've seen the advantages of the latter recently with regards to pandemic exclusions."

He explains that the first hurdle to clear should be to gain alignment between risk, HR and the CFO/procurement. "You need to get all these central stakeholders onboard first with a view to ensuring a successful captive programme. Having this in place will make discussions locally a whole lot easier because it basically says to local subsidiaries: this is the direction in which the company wants to go, if you don't want to place the business with the captive, you will need to evidence strong reasons why for any alternative direction," he says.

> **"It makes sense to add** more premium volume to help spread the [captive] costs over a broader base. And one area where you are going to find this volume already in place is employee benefits"

In the end, there are many different advantages from taking the captive approach. "The primary goals of an employee benefits captive programme are to increase governance and leverage economies of scale to maintain healthy and sustainable financial control," says Mr Almeida. "As companies strive to improve their employer value proposition – allowing them to attract and retain talent, with increasingly flexible benefits – they have found that captives can help them do that too."

DIVERSIFICATION

An important factor is the diversification benefits that EB brings to a captive. "In terms of employee benefits schemes being ceded to the captive, it is an interesting approach for a captive in terms of diversifying the lines, and in having the data, especially for loss prevention," says Sigurd Ruck's Mr Zucchi. "When you buy reinsurance to protect the portfolio of the captive, especially in our case where the P&C line of business is extremely volatile as it is oil and gas, the stability of the loss ratio that lines such as employee benefits bring gives more confidence to reinsurers on pricing and risks."

And Zurich's Mr Heini adds: "If you look at the last ten years amd how the regulatory and governance costs of running a captive have increased, it makes sense to add more premium volume to help spread the costs over a broader base. And one area where you are going to find this volume already in place is on the employee benefits side and, specifically, medical. A lot of the captives I work with are now finding that up to 30% of their premium volume comes from employee benefits. This additional volume not only helps to reduce the relative costs of running the captive in terms of percentage of premiums ceded but can also add valuable portfolio diversification benefits, which can be attractive in Solvency II regimes."

The view from Asia

◇ ROUNDTABLE

Tony Dowding
tdowding@commercialriskonline.com

The second virtual roundtable held for this year's captive report focused on Asia-Pacific (APAC) and brought together a group of captive owners, managers and fronters from Singapore and Australia to discuss the issues affecting APAC captives, looking at the impact of the hard market, emerging/uninsurable risks, growth areas in Asia for captives, and employee benefits. The roundtable was hosted online by headline sponsor Zurich Insurance.

The participants were: Stuart Herbert, Marsh Captive Solutions leader, Asia-Pacific; George McGhie, Willis Towers Watson, Singapore; Angela Marks, head of captive deal management commercial, Zurich Australia; John Bang, captive lead, Singapore, Zurich Insurance; Steve Tunstall, general secretary, Parima, and director, Tunstall Associates; and Kelvin Wu, treasurer, Parima, and group assistant general manager, risk management and insurance, International SOS. Parima is the professional association in APAC dedicated to developing risk management as a profession and providing a platform for risk and insurance managers to connect. See: www.parima.org

The roundtable was chaired by Tony Dowding, editor of Commercial Risk Online's *International Programme News*.

Tony Dowding: Does the hardening market mean a greater role for the captive? Does it make it easier to justify the captive's place in the company?

Stuart Herbert, Marsh captive solutions leader, Asia-Pacific: I think the answer is absolutely. The hardening market is generally a time when lots of people struggle and reach out for alternate ideas, and captives and protected cell companies are often top of that list as the great saviour. Although, as we know, they aren't necessarily always a saviour, they're a tool to facilitate.

APAC has been leading the hard market globally: very expensive, very aggressive both on capacity issues as well as coverage

We've certainly seen that the hard market has been going on for a while, and APAC, particularly Australia, has been leading the hard market globally: very expensive, very aggressive both on capacity issues as well as coverage. So, we are seeing tremendous growth coming off the back of that.

The question of whether it makes it easier within the organisation to justify or establish a captive is a mixed bag; it certainly raises the profile when you have your premium spend increase by 50% or 100% and have extra exclusions. It certainly gets insurance up to the board level, if it wasn't already, and significantly in audit and risk committees.

But it doesn't necessarily make it easier to justify the captive. I think the captive is a tool – it still needs

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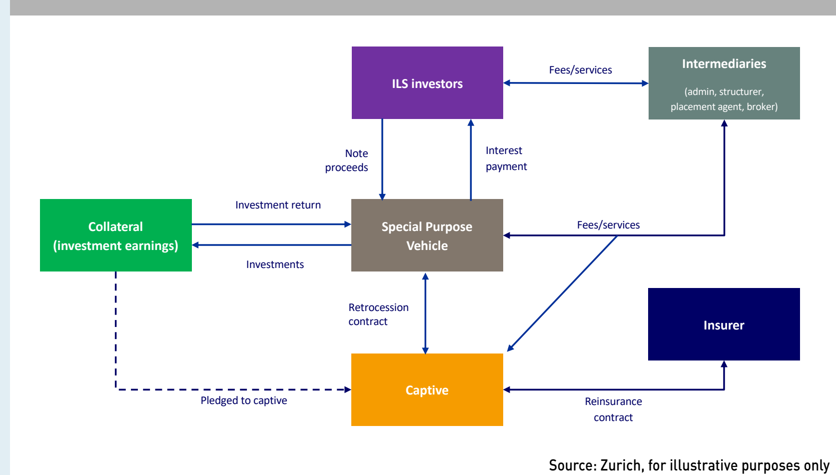
Capital markets as alternative reinsurance capacity supply

◇ PROTECTION

Joshua Nyaberi, CPA
Head of captive fronting, Zurich Captive Services

Tensang Dongtse
Captive fronting manager, Zurich Captive Services

Overview of a generalised ILS structure with a captive



Source: Zurich, for illustrative purposes only

The origins of insurance-linked securities (ILS) can be traced back to 1992, the year when Hurricane Andrew made landfall in the State of Florida. The (re)insurance industry at that time explored structured solutions beyond traditional concepts, given capacity shortages and the rise of premium rates, especially in the area of natural catastrophe risks (such as windstorm and earthquake).

During recent years, public awareness of ILS increased as well as knowledge building, which led to a multibillion-dollar infusion of alternative capacity for protection buyers looking for substitute and/or complementary solutions.

Investors providing the alternative capital stand to benefit too, particularly in the prevailing low interest rate environment, by adding assets with uncorrelated risks and generate respective returns to their investment portfolios. The most prominent ILS categories are cat bonds and collateralised reinsurance, and while they both have the advantages of fully collateralised protection, they also come with challenges (such as structuring, placement, time, modelling, legal and costs). The ILS market continues to innovate and evolve, while enabling legislation continues to be enacted across multiple jurisdictions, with one of the latest being the UK's ILS legislation of 2017. The UK's approach towards this industry could give momentum for further development.

In the recent past, we have observed from among our captive customers, and their brokers, an interest in innovative ways to resolve capacity shortage mainly in large property programmes. Faced with exposures that amount to excess of billions of euros in some cases, and which are potentially increasing over the years, getting adequate coverage becomes a challenge for some of the customers. The hardening market only increases that challenge as terms and conditions of coverage tighten and capacities offered get significantly reduced. Some of the common perils in scope are nat cat and in some cases contingent business interruption – such as a loss our customer would incur following an event at their suppliers, which in turn causes business interruption to our customer.

BRIDGING THE GAP

This is when innovative solutions in the alternative capital space come in handy to bridge the gap. In such cases, captives often do purchase reinsurance protection to protect their balance sheets across a wide range of perils and territories. So why not access the capital markets? There are a few hurdles and valid reasons that probably make captive owners rethink – for example, time and expense, size of exposure, type of perils or other factors – but this might change eventually when there is more volume transacted by captives and experience in the market. *(See chart above)*.

A captive offers great flexibility and therefore increases the options in an ILS programme structure design. For example, the captive could either act as an insurer or a reinsurer, and therefore transfer either indirectly through a reinsurer or directly to the Special Purpose Vehicle (SPV). The SPV then issues bonds to the investor community and the money raised from the bonds is put aside in a collateral account, which is normally invested in secure investment classes (such as US T-Bills).

Throughout its history, the ILS market has been tested by losses and proved its robustness. According to Aon Securities' Q2 2020 update on ILS, while this year's Covid-19 pandemic led to a brief interruption in the industry, like everywhere in the global economy and especially in the financial markets, stable new issuances so far have maintained the high level of outstanding deals. However, the uncertainties stemming from this pandemic and the economic outlook, plus an active hurricane season (which is not over yet) might increase pressure on reinsurance rates, which in turn could also impact the ILS market.

Zurich's Captive Services team is ready to work with captive owners that are potentially interested in ILS and will support them on that journey, thereby also exploring workable alternatives and collaborating closely with other ILS market partners.

to work for every organisation. It's not a panacea for everybody but I think it certainly gives people the right frame of mind to think of an alternate, as opposed to the traditional view, 'let's just keep buying because it's been available and not terribly expensive'.

Now, in many cases, insurance has become something that is not readily available and is becoming expensive. But the good thing to come out of all of it is that we're seeing risk managers raising their profile, which is always a good thing in my view because they can help drive intelligent and articulate conversations about risk management and how to deal with these issues.

John Bang, captive lead, Singapore, Zurich Insurance: Fundamentally, I think a hardening market definitely promotes the use of captives. Some risks can be difficult to insure in the commercial market, either because of a lack of suitable products for the risk or a lack of appetite from insurers, whether price or coverage. In both cases, a captive can be a helpful tool because a lack of options for transferring these risks means they are effectively being assumed by the company anyway, so eventually they need some sort of financing.

If there's only a few products or limited capacity in the market, captive owners can be less concerned about high prices as the captive is a very useful tool for cycle management. At the same time, the captive may generate higher profits and still meet arm's-length requirements as it operates alongside commercial markets and replicates their price development.

But if there are no products available in the market, captives will reach out to insurance companies like Zurich to create the product and set the price. I think the collaborative approach also enables the captive to tap into the knowledge and experience of the insurance company, which can eventually be very helpful in determining the retention, exercise benchmarking and creating facilities for reinsuring new products and previously uninsurable risks. As an example of this, we're seeing lots of enquiries on cyber risks.

Zurich's John Bang said a hardening market definitely promotes the use of captives

Tony Dowding: Is the captive ever used as a bargaining tool?

Stuart Herbert: Certainly, from my perspective, it has always been used for that. The question is now, with the premiums being so much higher, there's more attraction in deploying your own group capital against that. That's one of the things we've seen with captives not necessarily just playing in primaries – the traditional first ten million or so.

We are certainly seeing captives being established to take excess layer positions. They are saying: 'If the insurer is only going to charge 22,000 per mil at the primary but if we go up excess of 100 million and the insurer wants 28,000, 30,000, 35,000 per mil, why don't we take our risk there? It is more remote and we're getting a better saving.' We also experience it where insurers draw a line in the sand, saying: 'This is our price; it is a take-it-or-leave-it scenario. If you want to take more risk yourself, that's fine.'

Theoretically, it is a great tool to try and edge that extra competitive level out but, in this market, I'm not so sure it is adding that much value to that process.

George McGhie, Willis Towers Watson, Singapore: The key with a captive is that it gives you flexibility, it gives the buyer more options. It's not so much a question of using it as a threat to the market – clients have always got the option of retaining risk anyway whether through a captive or not – but it does increase the range of options that clients have in how they can manage and finance risk.

An option we see more often in hard markets is filling gaps in excess layers, as mentioned by Stuart. This is particularly valuable when you get situations where price in an excess layer can be driven by the most expensive participant. So, if you get towards the end of a layer and the last underwriters have driven up the price of a whole layer, it makes perfect sense to take that last portion of the layer out and put it in a captive.

Steve Tunstall, general secretary, Parima, and director, Tunstall Associates: I think there is less chance that the risk manager is a threat than the reverse. Certain markets seem to have essentially

taken this opportunity to punish risk managers. There's been a soft market for a long time; that's been the market's choice. As I've said at several conferences, I see some of the extreme examples of hardening as revenge pricing from certain elements of the insurance market at the moment. And that's not only a problem in terms of people putting more risk in their captive, but can also change corporate attitudes to the whole process of buying third-party insurance. Sometimes for better but also potentially for worse.

I deal with one (very well capitalised) client in particular, who in the aftermath of 9/11, and the traumatic pricing increases that followed, said that with that sort of approach, they would never use insurance for their property programme ever again. They now self-insure this element and have done for the last 20 years, because they felt the insurance market was too fickle.

This is one of the many issues the insurance market now has to address carefully as it hardens. I'm currently talking to another party about a policy where the premium offered by the incumbent leader with zero claims went from 1.5 million to eight million. If the market keeps doing things like that, then the message to the risk manager is that the market is irrational and can't be relied on, so they had better find a different way of protecting their risks.

Tony Dowding: With the hardening market, will the focus be on traditional uses of captives (getting better value for money, improved terms and conditions, etc)? Or will there still be innovation, an expansion in the use for captives in other strategic areas?

George McGhie: I think it will be a combination of the two. The captive's role is much higher up the agenda now for the c-suite than it would be in a soft market, and they tend to think less about risk in terms of insurance products. They are looking at risk as risk, and how they can best treat that, rather than the insurance products that are available. You need to identify the risk, evaluate it and look at your options for financing it, which is more vital in a hard market than when there is cheap and plentiful insurance to be bought.

As the price and availability of insurance becomes more difficult, punitive in many cases, then that opens up what would otherwise be considered conventionally insurable risks for alternative treatment such as a captive, often allied with reinsurance, perhaps on an ART basis, including cross-class and multi-year options. There's a whole range of different options as to how you're going to finance your risk, when you start looking at risk on that basis and stop thinking about traditional insurance products. If instead you focus on the risks of the group, then that opens up the conversation to look at alternatives on a much broader scale, for which a captive can be an ideal management and finance tool.

Kelvin Wu, treasurer, Parima, and group assistant general manager, risk management and insurance, International SOS: From a risk manager perspective, if you do not already have a captive or it is something new to you or your organisation, the likelihood is that your initial steps will involve sticking to something perhaps more traditional, more easily explained and understood. And the hardening market will make it easier to show the financial value of putting such an arrangement in place.

But if you already have the benefit of having a captive, there is more room for you to get creative. Speaking from personal experience on how we have been utilising the captive for International SOS, it is not dissimilar from the points raised by Stuart and George, which is about using the captive to plug certain gaps, not even in excess layers but primary layers, where the pricing has gone completely mad. We were still struggling to place 100% of the risk for certain programmes, which is why we have used the captive to come in and fill in those gaps.

I guess where we have gotten a little more creative is if you take the Covid-19 situation. We have a large

number of our employee benefits being underwritten to our captive. One of the issues was navigating the scope of coverages per country, as to whether there was a pandemic or Covid-19-related exclusion. Each government has its own approach as to what costs it is picking up in terms of the treatment and testing cost of Covid-19. So how does the company respond to employees that ask how they are being taken care of by the company if they are being asked to still work through Covid-19?

This is a benefit of the captive because we can say, 'this is the stand we want, notwithstanding the local terms and conditions of the underlying policies', and because of the captive we can make sure there are no pandemic-related exclusions for inpatient, outpatient, for term life. This is a good example of how captives are used to respond quite quickly to new situations. The longer you have had the captive being understood by internal stakeholders, then the more room there is for you to be creative in an environment like this.

Tony Dowding: Is the captive an appropriate vehicle to 'incubate' emerging/ uninsurable risks?

Angela Marks, country head of international programmes and captive management commercial, Zurich Australia: The market uses the term 'incubation' and emerging risk frequently. An emerging risk comes with uncertainty and therefore as a fronting partner we would expect to see a captive with a strong capital and equity position to support the potential volatility of such a risk. It may also require a form of collateral to support the transaction. In our experience under the current market conditions, customers are focused on traditional risks.

Steve Tunstall: I think that the idea of incubating an unusual risk in a captive and then taking it to a market makes sense, but I haven't seen that on some of the unusual risks I've been involved with. The need for self-insurance in the captive usually results from the market not being innovative enough to cover the risk. So, the captive then works out what it's got to do and learns along the way. By the time the captive gets comfortable with the risk, then they know more about it than the markets. So why push it back into the market if you've built up the capacity and resilience within the captive vehicle itself?

Having said that, I feel people are brutally fighting fires in their captives at the moment and I don't think there is bandwidth to get creative about new risks. Everyone is trying to figure out how to cover the existing risk we know we've got to deal with. So, for this year, I think that creativity is perhaps off the agenda for everyone except people who are extremely desperate.

Stuart Herbert: More recently, we're seeing innovations to a certain extent in the captive in the sense of just a wider remit of policy. So, we're seeing more D&O now being considered within policies, which is not something that has been a traditional market for captives. But the true incubation risk-type stuff, that's very much left to the wayside at the moment and clients are just managing by saying: 'I traditionally put property and maybe liability but now perhaps I do need some cyber, some of the D&O, all around that cost mitigation.' In a sense, using the captives more but not for unique risks – that really has been parked to one side.

Parima's Steve Tunstall said people are fighting fires in their captives at the moment, so there is no bandwidth to get creative about new risks

Tony Dowding: What are the growth areas in Asia for captive use in terms of locations, risks insured and types of vehicle? Is there any indication that global companies may look at having a separate captive for APAC risks?

Stuart Herbert: There are two main areas in Asia for captives: Labuan and Singapore. We are currently seeing a lot of growth in Singapore – that's principally because Singapore is a heavily Australia-focused market. A lot of difficulties are coming out of the Australian hard market, so we are seeing quite significant growth.

George McGhie: We've seen for the last 18-24 months a huge uptick in activity out of Australasia, which formed a large number of new captives. Geographic convenience is a big factor for Singapore and Singapore's regulations are really good – the MAS is highly professional and the reputation of the domicile is very strong.

Labuan is also a good domicile, with good regulation and a solid offering, and attracts mainly captive owners from Malaysia and other parts of Asia.

In terms of second captives, I think most have come about through acquisitions or mergers, and tend to think a single, well-located captive is a better option for most clients, unless there's a specific issue to address.

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John Bang: There are a lot of acquisitions and mergers involving Asian multinational companies, and when they acquire European companies that have a captive, that's a natural shift for the organisation to consider an APAC region for a domicile. So, we have had some enquiries from Asian multinational companies in that regard, and that could be an area of growth opportunity.

Kelvin Wu: From a client point of view, there's little reason to get another captive unless it's driven by regulations. That's usually the key motivation. We recently got involved in a second captive only because the underlying risk is in the US, and as with all risk in the US, there are specific regulations about what you can do offshore and onshore into the captive. You need something onshore in the US region for the captive to be able to work. If you want to be efficient, there is really nothing to justify a second captive unless there are regulations you need to meet.

Tony Dowding: Are APAC captive owners looking at writing life and non-life risks together in their captives?

Kelvin Wu: Does it make sense from a risk point of view? For sure, particularly in terms of spend for operations – it's quite significant. It is strangely one of the classes of insurance where cost inflation is less challenged than the other classes. Clients have almost resigned themselves to the fact that if they get medical inflation in the low-single percentages, that's a great outcome.

Obviously, one way to manage and contain that cost is to insure it into a captive to keep a closer look at the utilisation. I think a lot of the challenges around the tick-up rate of employee benefits and captives are more people-driven than by risk or technical issues. It's usually because the people leading the programmes, like HR, do not have a great understanding of the technical implications of captives, and risk managers who are leading the initiative are not doing enough of a job in engaging with HR and others internally to get buyins. This is more of an internal people issue as opposed to a technical or risk issue.

A lot of the challenges around the tick-up rate of employee benefits and captives are people-driven

John Bang: I've had extensive exchange with our employee benefits captive experts in the past few months and this is definitely a new trend in EMEA. Out of about 6,300 captives globally, only about 120 captives have employee benefits included so far, so there is huge growth potential. From our experience, Zurich only had one captive writing employee benefits in 2008 and currently we have 24, so this is definitely a trend we hope will move to APAC.

We found that virtually all employee benefits captive programmes that we acquired were initiated by non-life captives – it was not initiated by HR departments, but by risk management or insurance departments. The other thing we're seeing is that a lot of the employee benefits programmes are managed through a decentralised system, which means some of our European customers are willing to set up an employee benefits captive, or a combined non-life/employee

benefits captive, in APAC. We definitely think this has potential moving forward.

Tony Dowding: How big an undertaking is it for a captive to start writing employee benefits business in terms of time and effort?

George McGhie: It's an interesting area – I actually ran an employee benefits business in Asia for a large broker for quite a long period of time. I tried very hard to promote the use of captives throughout because it's a loss-rated line, so the premium is largely based on the loss experience. It responds, therefore, directly to improvements in risk management.

In Asia, group medical drives employee benefits programme costs, although the market does differ from country to country. You're looking at a wide range of regulations, not just insurance regulation but finance, employment, plus employment practices and customs, and collective bargaining agreements, so it can be complicated.

Making change in this space is therefore difficult, particularly given how emotional it can be for employees, especially when it affects their healthcare.

Angela Marks: Moving employee benefits risks into a captive will take considerable effort, particularly in the initial and implementation phases of the project. To be successful, this transition will require clear senior leadership and investment. Leadership is critical to address the potential differences between the HR and risk functions, which generally do not report though the same business unit, causing potential misalignment of objectives. Investment is essential, in both time and money. Experts in employee benefits can advise on the pitfalls and guide organisations on the best opportunities for quick wins.

Success is achievable and the benefits of the project can be considerable for captives. Employee benefits programmes provide insights on human risks and can help identify trends within the business. Global programmes can help the business attract talent by providing broader coverage than local market conditions, such as pre-existing conditions or age limitations. Premiums associated with employee benefits programmes can be significant when compared to general insurance products – this can help elevate the captive's importance within the business.

The process is not without its challenges. Employee benefits programmes are established using a bottom-up approach and are influenced by tax and labour laws, which can be complex. Employee benefits programmes are a long-term strategic decision; with the right investment, advice and leadership, they offer large corporates greater control over their business.

Tony Dowding: Finally, how much flexibility is there in captive pricing to actually be able to use it as a risk management tool for rewarding/penalising good risk management practices in subsidiaries?

Kelvin Wu: There is a degree of flexibility but obviously – with the increasing scrutiny of BEPS and transfer pricing in particular, and arm's-length pricing – this all needs to be taken into consideration. Within that, there is obviously still a range of flexibility, so what I have used the captive for at International SOS is to harmonise the level of deductibles for the business across different geographical regions.

Once you do that, there is some degree of flexibility, within the layer that is within the captive that is above the deductible, for you to reward good risk management practices or good loss experiences of local business units. But you need to work quite closely with your fronting insurers to develop pricing that you can then evidence as well, because it needs to stand up to scrutiny. And this has to be balanced versus the value you are trying to bring back to your business units, because one of the advantages that internally we champion to our business units and our regional managers is the stability of pricing, the certainty of pricing. Very often I find that certainty part is far more attractive to them than being rewarded for good loss experience or risk management.

Kelvin Wu has used the captive at International SOS to harmonise the level of deductibles for the business across different geographical regions

Stuart Herbert: We often see an alternate version, with captives creating risk improvement funds, which is captives setting aside some of their profits and asking how they can reinvest that into risk improvements within the organisation.

It's a tool for managing subsidiaries rather than the group risk, but we found that to be more engaging than saying a subsidiary must pay 20% more on its premium this year as it had a loss, or it gets a discount if it didn't have a loss. That tends to wear off very quickly and people forget the credit that they received, and then are upset that they don't get another credit. We try to shy away from that when we're talking to clients and we say this alternate funding-type thing is probably an easier way to reward businesses or improve businesses that need that help.

Survey reveals greater use of captives

◇ SURVEY

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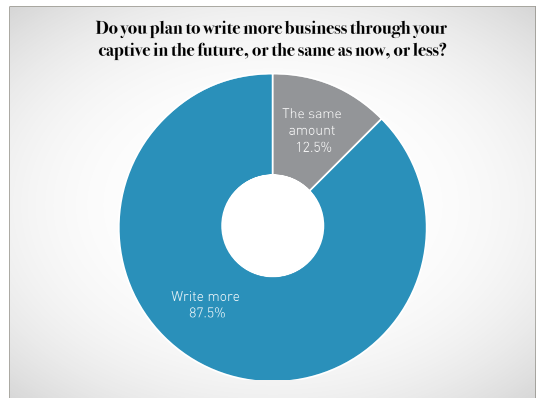
For this year's report, we once again carried out an online survey to take a snapshot of views on topics related to captives. The overriding conclusion of the survey is that the vast majority risk managers and captive owners plan to write more business through their captive in the future. It is also highlights that the hard market is well and truly here, particularly for property and directors and officers (D&O) liability insurance.

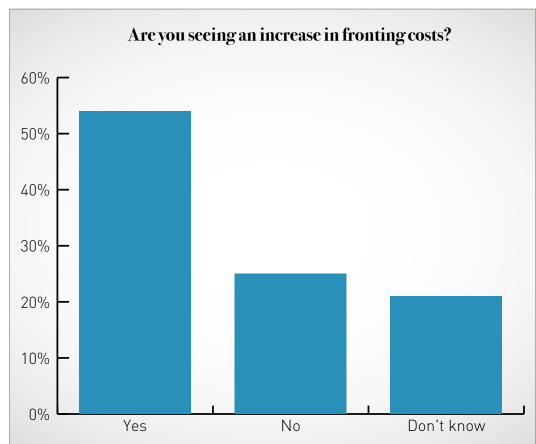
A hard market is of course a major factor in companies setting up a captive in the first place, or putting more business through an existing captive. And a hard market is not just about pricing. It is also about reduced capacity for certain risks, a greater number of exclusions, and much tighter terms and conditions.

We asked respondents which risks or lines of business are the most stressed in the traditional insurance market in terms of pricing, capacity, exclusions or terms and conditions. The class mentioned most often was D&O, highlighted by more than two thirds of respondents (71%), followed by property (58%), liability/casualty (25%), professional indemnity (25%), and commercial crime (13%). Other classes mentioned as being stressed include cyber, auto, excess, construction, and marine. In last year's survey (2019), it was cyber that was the class mentioned as seeing the greatest hardening, followed by D&O liability, and property.

MORE BUSINESS

The survey revealed that 87.5% of captive owners intend to write more business through their captive in the future, which is not surprising considering the severity of conditions in the traditional market. A further 12.5% said their captive would write about the same.





This compares with last year's survey, which found that nearly three quarters of respondents (71%) planned to write more business in the future through their captive, and 29% aimed to write about the same amount of business. No one, this year or last year, said they were planning to write less business in the future via their captive, unsurprisingly.

More than half of captive owners said they were seeing an increase in fronting costs (54%), with a quarter seeing no increase and 21% unsure.

Two thirds of the captives in the survey were wholly-owned single-parent captives, with just a handful of cell captives. Only a small minority of captives (17%) are involved in third-party underwriting, while nearly half of respondents (46%) have consolidated or are considering consolidating life and non-life risks in their captive.

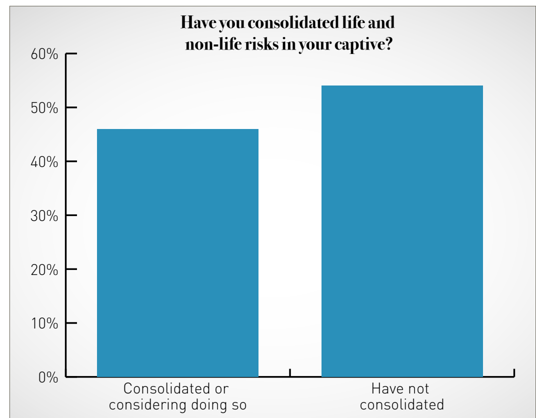
On the subject of using a captive to 'incubate' emerging/uninsurable risks, only 29% said that their captive did so, or planned to, with 46% saying that they did not, and 25% unsure. This is surprising, as two years ago in our survey, just over 50% said they would 'incubate' difficult emerging risks in their captive.

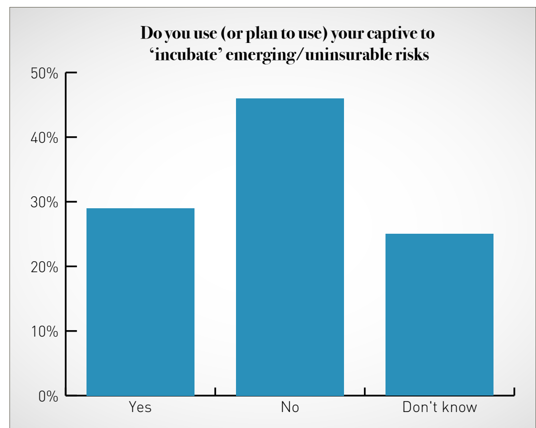
This may be because captives are focusing on traditional classes that are being stressed by the hard market, reflecting the difficulties in securing cover at the right price. Risk managers and captive owners simply may not have the time at the moment to bring emerging/esoteric risks into their captives, and are therefore focusing their efforts on the important traditional lines such as property.

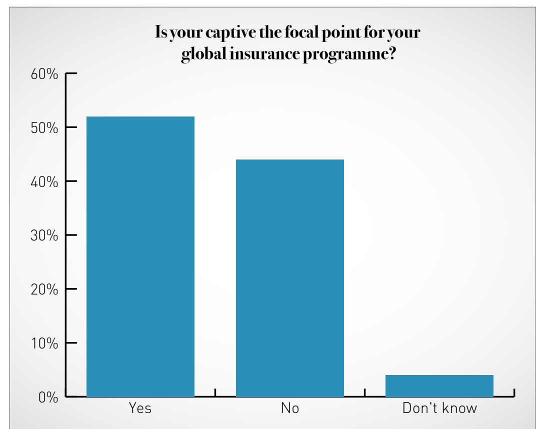
FOCAL POINT

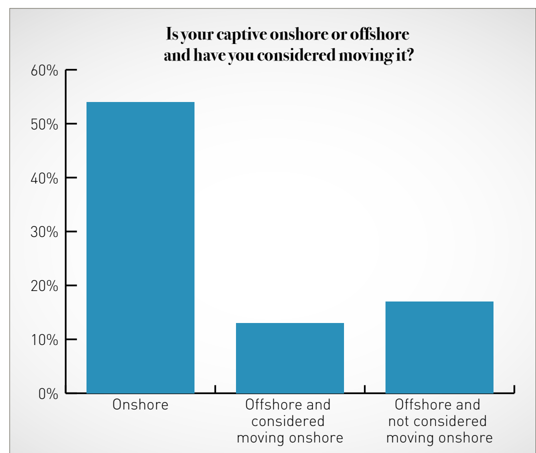
More than half of captive owners (52%) said that the captive was the focal point for their global insurance programme, while 54% use their captive to gain access to specialist excess or reinsurance markets.

Finally, captive owners were asked if they had redomiciled, or considered moving, their captive in the last five years. More than half (54%) said their captive is onshore, with 13% saying their captive is offshore but they have considered moving it onshore, and 17% having an offshore captive but not having considered moving it onshore.









The view from European domiciles

◇ DOMICILES

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GUERNSEY

Where is captive growth predicted to come from?

Peter Child, head of European operations and managing director, Artex Guernsey: "The quick answer is everywhere and every industry. The argument for taking advantage of the captive concept becomes particularly compelling in a hard market. The current hard market is affecting everyone who purchases insurance, and those who have a good grasp of their own risk profile and risk appetite are commissioning feasibility studies and setting up captives at an accelerating rate. More specifically, in terms of geography we would expect some of those areas that have not historically seen a wide use of captives to experience strong growth, for instance eastern Europe and South America. We would also expect the captive concept to be taken up by more SME-size companies."

Do you expect to see sustained growth in the next few years?

Mr Child: "As long as the hard market persists, there is no doubt that growth will continue. Just as important as the growth in numbers though is the growth in premiums written by captives and the capital that is used to support those premiums. A captive is not a short-term fix, it is a medium- to long-term tool that is used to increase the efficiency of the risk financing function. Therefore, I would expect the captives that are being established now to grow and be used for more disparate risks as they bed down within their organisations over the coming years."

What are the latest statistics on captive numbers?

The hardening market has seen Guernsey attract 11 new captives to the domicile in 2019, more than double the number last year, according to Guernsey Finance. It said the island saw a large increase in enquiries in the second half of 2019, following slow demand for new structures in recent years.

The 11 new structures in 2019 were four cell company captives, taking the total number in the island to 106, and seven non-cellular captives. There were also 20 authorised managers at the end of 2019. There were 24 surrenders during the year, seven cell captives and 17 captives. At the end of 2019, Guernsey has 305 registered captives. Guernsey Finance noted that risks underwritten by Guernsey captives include employee benefits, employers' liability, marine and aviation risks, and terrorism.

Growth is coming from increased use of existing captives in Dublin as captive owners negotiate their 2020 renewals

IRELAND

Where is captive growth predicted to come from?

Gerry Connell, SVP, Dublin, Marsh Captive Solutions: "With a return to more aggressive pricing from the insurance market in recent times, probably driven by lower investment returns, we are once again seeing an increased use of captives to satisfy the insurance programme requirements. It is still a little early to see what impact Covid-19 will have on the insurance industry and if that might create conditions for further growth opportunities for captives in the future.

"The growth may not come from new captive formations but from increased use of existing captives. This is something we are

seeing in Dublin as captive owners negotiate their 2020 renewals. Due to price increases, policy cover exclusions or increased deductibles being applied, some clients are increasing the use of the captive to restructure their programmes to suit their needs and reduce their reliance on the insurance market."

Do you expect to see sustained growth in the next few years?
Mr Connell: "We are continuing to see a good degree of interest in new captive formations but these prospects will take time before a decision is made to set up. These enquiries are due to the traditional reasons of insurance market pricing, coverage and capacity, and focused on the traditional insurance classes of property damage/business interruption, liability and marine cargo, along with employee benefits and cyber risks. For the same reasons, we are seeing growth opportunities in the existing Dublin-based captives too."

Has there been any new legislation?
Mr Connell: "European AML legislation brought in requirements for EU member states to establish a Register of Beneficial Owners of all companies by 2019. Captives, like all other companies in Ireland and across Europe, established a register and filed details with the national registrar. This is an administration requirement going forward, carried out by the captive manager/company secretary, but an important one.

"Since its introduction in 2016, Solvency II regulations and how they are applied to captives in terms of the principle of proportionality, remain the greatest challenge for captives domiciled in Dublin. The captive industry welcomes the Eiopa review of Solvency II currently underway, which may address, or at least in part address, some of the industry's concerns on proportionality and how it may be applied in Dublin for the future. This review is now delayed due to Covid-19."

What are the latest statistics on captives?
The number of captives in Dublin had decreased over the years, due mainly from run-off entities being liquidated or other entities closing for other reasons such as merger and acquisition of the parent or, in some cases, a move to another domicile. This was offset to some extent by new formations and, in some cases a move to Dublin from another EU domicile. The number of captives in Dublin currently stands at approximately 78, with premium volume in the region of $375m in 2019.

ISLE OF MAN

Where is captive growth predicted to come from?
Karen Shimmin, senior account manager, Thomas Miller Captive Management: "We have seen particular hardening of the traditional insurance market across financial lines, property and casualty, and cyber risks. As the market continues to harden, with premiums increasing, reduced cover and insurers withdrawing capacity, even on a 'clean risk' we are seeing hardening across these lines of business, which makes the captive prospect very appealing. We have seen several enquiries from IFAs in respect of PI cover, which seems to be an area of significant concern for underwriters at the moment."

Do you expect to see sustained growth in the next few years?
Ms Shimmin: "The traditional insurance market is hardening and we expect this to continue over the next few years. This paves the way nicely for the captive insurance market to use this as an opportunity for growth. We're seeing more interest and activity than ever, with enquiries from people that are now seeing the merit and value of a captive and enquiries from existing captive owners looking to utilise their captives to fill gaps in their current programmes or introduce new lines of business into the captive. As traditional market conditions become more challenging, we can see captive owners able to use their captives to create competitive tension in the market and influence renewals. We have also seen a lot of interest in cell captives."

Has there been any new legislation?
Ms Shimmin: "The authority has maintained a roadmap for updating the Isle of Man's regulatory framework for insurance business. The roadmap was first issued in June 2013 to provide an overview of a significant update to the Isle of Man's insurance regulatory framework, which is consistent with the authority's aims of ensuring that the island has a proportionate and robust regime for the regulation and supervision of insurance business, as reflected in developments in relevant international standards."

"The authority has now issued the February 2020 roadmap, which provides regulated entities and other relevant stakeholders with information on progress over the past six months and looks ahead to significant workstreams during the next year. Importantly, in the process the authority has not only undertaken extensive consultation but it has also worked closely with the Isle of Man Captive Association to ensure that the enhanced legislation is both relevant and appropriate."

What are the latest statistics on captives?
The Isle of Man currently has about 115 authorised captive insurance companies.

LUXEMBOURG

Where is captive growth predicted to come from?
Claude Weber, managing director, Marsh Captive Solutions, Luxembourg: "In Luxembourg, growth is expected to come from the traditional geographies, such as France, Belgium, Spain and Germany. The majority of business will probably continue to come from continental Europe. It is difficult to select any particular industry. Due to premium increases and

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reductions in capacity in numerous markets, companies from almost all industries are re-analysing their captive strategies in to order to find the appropriate response to these market trends. Impacted coverages include risks such as PDBI, PI, liability, cyber, and employee benefits. There are also companies that have been severely affected by the Covid-19 crisis that are looking for coverage such as event cancellation and BI coverages linked to pandemic events, for example.

"Currently, we are seeing a lot of interest in new captive projects and in increasing captive retentions and new lines written by captives due to the market changes. In addition, more captives are getting interested in employee benefit programmes. By year-end 2020, we would expect an interesting increase in captive numbers and premium volumes, and expect this trend to continue for the future."

Do you expect to see sustained growth in the next few years?

Mr Weber: "Before Covid-19, a strong change in pricing philosophy could be observed as a reaction to reduced returns on investments as a result of the wider financial climate and low interest rates, as well as rate decreases across most lines of business observed during the last 20 years. Since 11 September 2001, the market has mostly seen premium decreases. As well as rate increases, a number of players have completely withdrawn from certain markets or have substantially reduced the capacity they are willing to commit. As long as this trend continues, there should be sustained growth in the captive market, including an increase in the number of captives and the level of retentions kept within the captives."

Has there been any new legislation?

Mr Weber: "In the last year, there has been a substantial push for more efficient compliance policies in relation to AML, terrorist financing and embargos. In addition, more reporting requirements have been added with regards to shareholding structures and tax issues. This, combined with the effect of Solvency II, which needed to be implemented during the last few years, has added quite some complexity in the organisation processes of captives. The next challenge, IFRS 17, will probably have less of an impact for most Luxembourg captives, as Luxembourg intends to continue applying LuxGAAP for our accounting."

What are the latest statistics on captives?

In the last ten years in Luxembourg, the number of captives have substantially decreased and as of the end of April 2020, there are 196 reinsurance companies and approximately 15 direct insurance captives. Premium figures have, on the other hand, increased from €7.9bn in 2010 to €10.3bn in 2018.

MALTA

Where is captive growth predicted to come from?

Ian-Edward Stafrace, chief strategy officer of Atlas Insurance PCC:

UK and Gibraltar-based companies can maintain direct access to the EU single market through Maltese cells

"Enquiries and engagements have significantly increased during the past two quarters. There has been a general reduction in market capacity that has contributed to this. Insurers have become much more risk averse, which will likely increase with Covid-19. Some insurers have ceased to underwrite some classes and others have closed entirely. This causes uncertainty on continuity for insureds and distributors and increases the justification for the setup of captives or cells.

"Another key source of growth is connected to Brexit. To avoid the use of fronting insurers or the need for multiple branch authorisations per country, UK and Gibraltar-based companies can maintain direct access to the EU single market through Maltese cells. On the flip side, access to the UK market can be maintained via a single UK branch authorisation."

Stephen Portelli, office head, Marsh Management Malta: "We are seeing interest from various countries and industries, especially those that write business in the EEA. The driver is that we are in a transitioning market and both capacity and prices are increasing, which makes it more attractive for risk retention vehicles."

Has there been any new legislation?

Mr Portelli: "IFRS 17 is a challenging new accounting standard, however throughout the history of captives significant new regulations came into play and the captive industry was always able to adapt. The captive industry tends to be resilient, and engaging with the right insurance manager enables the captive owner to survive and thrive through these legislative changes."

What are the latest statistics on captives?

In 2019, Malta saw a 7% net increase in non-domestic insurance undertakings to 62, including eight pure captives and 15 PCCs with a significant 67% net increase in licensed insurance cells to 60. Malta saw €4.6bn gross premium in relation to risks situated outside Malta in 2019, increasing by 12%.

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