Growing Role For Captives

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Commercial Risk Europe

Insurance & Risk Management News

Growing role for captives

COMMERCIAL RISK EUROPE'S CAPTIVE SURVEY 2018

INTRODUCTION

One of the greatest strengths of the captive sector has been its adaptability. As markets have hardened and softened, as new risks have emerged, and new requirements from companies have challenged the insurance industry, the captive has adapted and taken on all the challenges and changes.

Indeed, a recent AM Best report says the captive market just keeps growing and growing and growing. It states: "The rated captive segment remains exceptionally strong and continues to outperform its counterparts in the commercial casualty segment. The biggest challenge for us was finding new or interesting ways to describe the persistently good news."

The current challenges in the insurance market are also great opportunities for captive insurers. Current conditions suggest that captives should be writing more business and taking on more risks. Firstly, there is the possibility of a hard market, at least in some classes and regions. Then there is issue of some captives finding themselves with surplus capital, partly as a result of Solvency II. Then there are the emerging risks such as cyber, and risks that offer diversification and new opportunities such as employee benefits business. And with the correct reinsurance programme, captives can look to take on more risk and new lines, and grow their businesses.

This report examines all of these issues and explains how captives are in a perfect position to respond to these challenges. And history suggests that they will do exactly that, and continue to provide solutions for their parents.

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Preparing for a possible hard market

◇ OUTLOOK

Tony Dowding
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Is a hard market on its way? Certainly, market conditions have been changing and generally, the market is no longer softening. At this year's Monte Carlo Rendezvous, Swiss Re's group chief underwriting officer said that pricing dynamics for non-life insurance have reached an inflection point, but added that it was too soon to declare a return to hard market conditions.

That was of course before the recent cat losses, including Hurricane Florence, which is estimated to cost insurers between $2.5bn and $5bn, and Hurricane Michael, which current estimates suggest will see insured losses in the $6bn-$10bn range.

Hurricane Florence viewed from the International Space Station

UNCERTAINTY

The jury is out, it would seem. Or rather, it appears that it depends which line of business is being discussed, or what region of the world. It seems that the days of describing the entire insurance market as hard or soft or flat have long gone. The reality is that the market is hard in places, soft in others and flat elsewhere. Some lines, such as commercial auto in the US, are undoubtedly hardening and have been for some time. But other classes and regions are flat at best, and some are still softening.

Christian Wertli, head of innovative risk solutions and director of corporate solutions, at Swiss Re Corporate Solutions, says that he sees a mixed picture. "Some carriers are cutting capacity. Others are expanding and entering new markets with compromises on rates. Overall, we observe a flattish rate environment with pockets hardening," he says.

He explains that North America is flattish, with partial rate increases on general property and nat cat for loss-affected risks but slightly down on benign risks, and flat for casualty risks. In Europe, he says rate erosion has stopped with partial hardening pockets, while in Latin America, there is still an abundance of capacity, and rates are either flattish or going down. In Australia and New Zealand, general property, energy, mining and utilities, as well as finpro, are hardening.

> **"Some carriers are cutting capacity.** Others are expanding and entering new markets with compromises on rates. Overall, we observe a flattish rate environment...

GLOBAL FACTORS

"Obviously, insurance markets don't function in isolation and are affected by the global economy. In our view, global growth remains above potential but the peak is behind us and reginal divergence is rising. Risks remain tilted to the downside, particularly amid intensifying trade ten-sions between the US and China. Growth in the US and China will face headwinds from increasing tariffs. The BEAT tax imposed by the US might also contribute to the higher frictional cost and hence,

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higher premium rates," says Mr Wertli.

He explains that there is still an abundance of capital in the market and while the rate erosion has flattened out, insurers will need to suffer more losses before they are going to cut meaningful capacity and before rates harden significantly. There have already been a number of nat cat events in 2018 that might have an influence on insurers' capital and therefore on rates, but economic losses from catastrophes in the first half of 2018 declined to $36bn, compared to the $64bn recorded in the first half year of 2017. Estimates about how much Hurricane Florence and Super Typhoon Mangkhut will cost insurers are still outstanding, says Mr Wertli.

Nuno Simao Antunes, senior vice-president, head of multinational – EMEA, AIG, says: "In certain lines of business there is a hardening of rates. But it is probably pushing it a little bit too much to say there is a general hardening of the market. What we are seeing now, as the world is becoming so data rich, is much more discreet hardening, with certain lines of business or certain geographic areas, or certain exposures that are more affected than others. In the past we may have seen a more generalised hardening of the market after a big catastrophe loss, for example. But now it seems to be more discreet and it is in certain pockets rather than widespread."

According to Marsh's latest *Global Insurance Market Index*, insurers are being more discerning in their underwriting, so conditions are more challenging than in previous years. In the second quarter of 2018, global commercial insurance prices increased by 1.2%, representing three consecutive quarters of increases.

Looking at pricing around the world in the second quarter, *Marsh's Global Insurance Market Index* showed:

- In the UK, average prices increased 0.8%, for a third straight quarter of increases. Pricing increased by 5% across financial and professional lines, especially in D&O and professional indemnity, while property and casualty pricing fell.
- Conditions were more favourable in continental Europe, where rates fell 1.5%. Casualty rates have now fallen for seven consecutive quarters. Property, and financial and professional, rates also fell.
- Pricing in Latin America increased for the third straight quarter, led by casualty and financial and professional. Property pricing fell slightly for the second straight quarter.
- In Asia, property, casualty, and financial and professional lines all decreased, on average, but at a slower rate than in the past for both casualty, and financial and professional, lines.
- Lastly, pricing increased significantly in Australia – by 13% in the second quarter. Rate increases were seen across all major lines, with financial and professional pricing increasing more than 23%.

CAPTIVES WRITING MORE

Peter Child, managing director – Guernsey, Artex Risk Solutions, says there are distinct signs of hardening in some markets, for instance Australian property, UK D&O and general aviation, but on the whole the market remains flat. "Whether the whole market turns will depend on a confluence of two things: losses driving premium pricing and [the] investment environment. I think it is likely that we will continue to see certain parts of the market harden, while capital will continue to be drawn to sectors that are perceived to be predictable and provide a seemingly reliable return, thereby keeping those sector flat/soft," he says.

If a hardening market, albeit in certain areas, is becoming a reality, the question is whether companies should be preparing to write more through their captive. Or should they be writing more anyway?

It would appear that many captive owners are looking at increasing retentions and making greater, and more effective, use of their captives. The captive is a useful solution, not only for retaining risk, but also as a bargaining tool when going to a market that is looking to increase rates or impose tougher terms and conditions. It is also a flexible tool and well suited to be able to respond to either hard or soft conditions in particular markets and classes.

"Captive owners will be reviewing their programmes and asking whether they should be taking on more risks where there is a hardening in the market, or lower risk retentions if they feel there is a really good reinsurance deal," says Mr Antunes. "Many companies with large captives take a long-term view, and the value of the captive programme goes far beyond the price of the risk transfer at a given moment in time. So a soft market doesn't particularly affect them, at least in the sense of questioning the existence of their captive. All of this will be taken into consideration, and there may be adjustments. This is part of the ongoing management of the captive, but it is now very much a line-by-line exercise."

According to Matthew Latham, global head of captive programmes, XL Catlin, AXA XL division: "Writing more lines of business through a captive, especially ones that are non- or lowly correlated, can generate greater risk diversification, reduce volatility and optimise capital efficiency."

"**Many companies with large captives take a** long-term view, and the value of the captive programme goes far beyond the price of the risk transfer at a given moment..."

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He says that the other lines of business attracting increasing interest among captive owners fall into two broad categories:

- Risks covered by established insurance markets that historically have not been placed in captives; these include environmental, trade credit and cyber
- Emerging risks where risk transfer solutions are either unavailable or prohibitively expensive; these include intellectual property, brand/reputation and supply chain.

He adds that with the second category of risks, the impact of not having cover means the business could be subject to significant and unexpected losses, and the captive could be a more capital-efficient vehicle for financing these losses, especially if it is supported with external reinsurance.

"Companies [that] use their captive for genuine risk management purposes should definitely write more risks, especially for risk where they want to design and manuscript their own policy form," says Mr Wertli. He notes that a captive also allows the company to incubate risks (such as for cyber or non-damage business interruption).

Mr Child believes there is no one rule: "Each captive owner should routinely be assessing the value of their captive according to their own assessment of total cost of risk, their own risk appetite, and the wider insurance environment. The main lines that continue to trend towards captive participation are employee benefits and, to a lesser extent, cyber."

Rob Geraghty, international sales leader, Marsh Captive Solutions, says that more risks are being written through Marsh-managed captives. "We have seen many companies adding non-traditional lines of business to their traditional property and casualty lines. Cyber is up an average of 26% per annum in the last five years – with over 40 captives now writing this – and employee benefits are up 21.8% in 2017. Political risk is also trending and has been insured and reinsured through captives, and in recent years is up an average of 20%. Most recently, trade credit has been a key talking area amongst captive owners and reinsuring of this through the captive has also increased," he says.

CAPTIVE VALUE

A change in the longstanding soft market would of course make it easier to justify a captive – as prices increase, capacity reduces and choice starts to disappear. In a soft market, where it is cheaper to transfer risk than to retain, a captive might seem less relevant. But the soft market has not particularly impacted the captive sector, perhaps because of the increasingly strategic use of captives in recent years.

As Mr Latham explains, there has not been a significant reduction in captive numbers in recent years despite the market remaining competitive. He says this is because captives and their owners have adapted strategies to ensure that the captive:

- Continues to add value to the parent organisation
- Stays relevant by taking on new risks
- Reinforces the risk management benefits associated with retaining risk, especially a heightened focus on preventing/minimising risk.

One area that may cause concerns for companies is the level of merger and acquisition (M&A) activity. As Dr Paul Wöhrmann, head of captive services EMEA, LatAm and APAC, commercial insurance, Zurich Insurance Company, explains: "The increasing M&A activity in the insurance and reinsurance sector could become a concern for large multinationals when selecting global insurance providers, because their options might become very limited. As a reaction, large corporate insurance customers might try to pursue stronger market arbitrage via their captives to avoid falling victim to an 'oligopoly trap', and to respond to the insurance market cycle dynamics."

Dr Paul Wöhrmann

He adds: "On the other hand, international companies which do not have access to a captive or virtual captive can't respond in the same manner. A more active utilisation of reinsurance captives could in turn lead to an additional fee opportunity for fronting insurers, if they are experienced and flexible enough to serve reinsurance captives in an efficient manner."

Perhaps one way to assess the captive's value is to look at how captives compare to the commercial market. A recent study by AM best compared the results of the 140 rated US captives in Best's captive insurance composite (CIC) and the commercial casualty composite (CCC). The study reveals that captives' results continue to clearly outpace the underwriting and operating results of the CCC – for example, the CIC's 86.4% and 88.0% five- and ten-year combined ratios, compared with the CCC's respective 99.9% and 101.4%.

According to Best, the reasons for the CICs outperforming the CCC remain:

- The captives' ability to efficiently and prudently manage and mitigate losses
- Their robust and focused risk management programmes
- Their ability to control cost of risk
- Their efficient use of reinsurance and flexibility to avoid or minimise the effects of general insurance market cycles and thus minimise price volatility
- Their focus on writing more profitable coverages and limits with low severity.

It also points out that the main advantage for captives is that they have a significantly lower underwriting expense ratio compared to commercial insurers (about 18 points annually, compared to the CCC's c.30 points).

Visit us at stand #116 while at the European Captive Forum in Luxembourg, 14 to 15 November.

Making the best use of surplus capital

◇ CAPITAL

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The past few years have seen captives focusing on capital and solvency levels, especially EU-domiciled captives as a result of Solvency II. Captives have faced higher minimum capital requirements, and the ongoing soft market conditions have meant retentions have reduced as companies have taken advantage of cheaper pricing in the insurance market.

The result has been that many captives find themselves with a surplus of capital. Captives are generally cautious when it comes to capital and liquidity. There are various options for the captive parent as to how to use that excess capital in the most efficient and beneficial way. One is simply to dividend back to the parent, or loan to the parent. But in the context of a potentially hardening market (in places), and the need to tackle new and emerging risks, it may make more sense for the captive to use that surplus to write more business.

Stuart King, president and CEO, Strategic Risk Solutions (SRS Europe), says: "For most captive owners, the risk-based capital calculation approach to Solvency II resulted in many captives seeing an increase in their capital needs, particularly captives underwriting large property programmes and the catastrophe capital charge. That said, many do maintain a healthy and stable solvency margin with a low, if any, dividend policy. But not as excessive as some might think."

Some captives have built up excess capital as retentions reduced as a result of falling wholesale prices. This has then either been released as dividends, or used to increase retentions or write more risks. "The surplus is being used in some cases to write more business," says Peter Child, managing director – Guernsey, Artex Risk Solutions. "I'd say there's a fairly even mix between using the capital to take more insurance risk, fund other risk management/mitigation-related activities, or return to the parent for other investment purposes."

GROWTH PLAN

"We have definitely seen a trend of captives trying to write more business and expand the coverages over the last few years," says Nuno Simao Antunes, senior vice-president, head of multinational – EMEA, AIG. "Some captives, perhaps as a consequence of Solvency II and capital requirements on the cautious side, have accumulated capital. And so they are looking to the market to find ways to expand and trying to become more strategic to the parent company. On the one hand it might be about getting involved with more territories, or it might be about more lines of business being retained by the captive. So it is about the captive playing a more pivotal and strategic role in the risk management strategy of the company."

He adds that AIG has been seeing an expansion into lines such as third-party business involving customers, cyber, marine programmes, trade credit, and some environmental liabilities related to the EU directive and financial guarantees. Also non-damage business interruption and reputational damage, where captives are taking retentions on risks that the market is not so comfortable with. And finally, employee benefits where there is a huge margin for growth as less than 200 captives around the world seem to be involved in this type of exposure.

It is not just about writing new

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business and expanding coverage in the captive. As Alexandra Gedge, business development and captives executive, JLT Group, points out, it depends on the captive and the appetite of the parent. "Usually, if your captive is making money it would make sense to consider retentions or additional lines of business, as that would generally indicate a good risk. However, it can be the right thing for the parent to use money elsewhere, such as risk management or dividends. Captives can utilise consulting revenues, or pay for additional risk services such as risk management or analytics. This can be a great way of identifying potential future losses and mitigating them."

According to Marsh, in 2017, Marsh-managed captives had shareholder surplus totalling more than $106.3bn. It says intercompany loans continue to constitute a material proportion of the overall assets for captives. Many companies use intercompany loans (approximately 33%) to loan these funds back to group, reflecting the very low levels of yield available on cash and fixed-income investments. During the past few years, Marsh says it has seen various stimuli for reducing the amount held in intercompany loans, including direct regulatory influences (with regulators restricting the size of these loans for some captives) and indirect influences (for example, with Solvency II, in some cases the intercompany loans may attract a relatively higher capital charge).

"Some companies are using surplus funds to enable captive parents to develop creative risk financing options," says Rob Geraghty, international sales leader, Marsh Captive Solutions. "Companies can utilise captive surplus to take on additional limits, write new lines of business, or fund loss-control initiatives. Many captives write third-party risk such as extended warranty as a potential new revenue generator."

He adds: "There are many ways a captive's surplus can be utilised effectively. However, the manner of which is generally company-dependant and reliant on the goals of that company going forward. Some innovative ways we are seeing companies utilising these surplus funds are to reduce costs and fund analytics to attain optimal programme."

According to Marsh, costs can be reduced by accelerating the closure of legacy claims, carrying out third-party administrator audits, fleet safety programmes and business continuity planning, for example. In terms of funding analytics, it points to areas such as efficiency of risk transfer, analysis of optimal risk retention, cyber business interruption quantification, and property valuations.

RISK CONTROL

Mr King says there is a general trend for risk managers to use captive funds for risk control studies or new emerging risk financing feasibilities: "This helps from an internal group budgeting perspective as the risk management department often achieves a degree of flexibility by drawing funds from the captive versus directly from the risk management bucket. The Solvency II Own Risk Solvency Assessment is proving to be very useful for captive board members and is really driving the agenda as to what can be done with their captive."

He says it is definitely the case that captives are getting a higher chair at the executive-level table and being more part of the enterprise risk management/finance discussion, and he sees this trend increasing with emerging risks such as climate change or more traditional risks such as trade credit.

Mr Child says he has seen captives both fund and provide other risk management/mitigation-related activities including: advanced actuarial studies; physical risk management surveys; cyber risk improvement actions; staff education programmes; asset valuations; and physical risk mitigation implementation.

For Mr Antunes, it is all about data and how it is used: "Clients are much more eager to get data than in the past. It is about capturing the data and then making it available, and getting insights from the data. Clients want transparent real-time data on policy issuance, premium payment and insights around claims. The transparency, accessibility and sharing of data is key, because it can inform the decisions of the risk manager around prevention and mitigation means, and the captive around what risks they may want to retain or not."

US TAX REFORM

The recent US tax reforms are also having an impact on captives and the risks that they are looking to participate in. According to Marsh, the recent reforms and the new corporate tax rate of 21% (down from 35%), mean that the economic benefit of the accelerated tax deductions that are afforded to captives drops proportionally. But this does not seem to have caused a significant drop in captive formations.

"In fact, there has been a noticeable shift in focus from tax benefits back to risk management; prospective captive owners are focusing on how a captive can lower the economic cost of risk by assuming coverages that are overpriced or unavailable on the commercial market. This is not only better from the IRS's viewpoint, it's also better for the health and longevity of an organisation's captive," states Marsh, in a recent briefing.

It also points to interest by current and prospective captive owners in exploring the value of utilising a captive as a profit centre by insuring third-party risks. "Since income is now taxed at the lower federal rate, captives are able to retain more of their underwriting profits on business such as employee benefits, mainly voluntary benefits like critical illness, hospital indemnity, accident, and legal insurance. Similarly, there has been an increase in activity by captive owners exploring the value of reinsuring extended warranties. Like the voluntary benefits, these tend to be a very profitable line of third-party business," says Marsh.

Designing the reinsurance programme

◇ REINSURANCE

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The reinsurance market has long been open to the captive sector, and while captives only represent a small market and individually are only, in effect, quite small insurance companies, they do offer a 'good bet' when it comes to risk. Most captives have intimate knowledge of the risks they are underwriting, and those risks are generally managed better (if an organisation has a captive, then it will take risk management and risk control more seriously, at least in theory).

A recent study from AM Best states: "The aims of single-parent captives (SPCs) – those rated by Best as well as virtually all SPCs around the world – are closely aligned with their parents' corporate risk management programmes. These programmes are often supplemented by robust processes for loss control, safety and risk management, that make captives even more attractive to the reinsurance market."

And the reinsurance market is a good option for the captive sector, given that reinsurers are the ultimate risk takers and specialists in catastrophe business. Captives will generally have a fairly low attachment point in the early years, since they have relatively low capital on startup, and need protection at a much lower level. Once the captive has had time to build up reserves, it may feel more comfortable about its ability to take a bigger "hit", and can then move its attachment point further up the scale.

Access to reinsurance markets is often part of the raison d'etre of a captive. Indeed, according to Marsh's *2018 Captive Landscape Report: 50 Years of Risk Financing Innovation*, access to the reinsurance market (42%) was the second most common reason for maintaining a captive, after "a formal funding vehicle to insure risks that the parent company has decided to self-assume" (60%).

STRUCTURE

But what about the actual structure of a captive's reinsurance programme? What considerations affect the structure of such a programme? "Naturally, first and foremost, is the risk appetite of the captive – so how much risk they want to take and for what price," says Alexandra Gedge, business development and captives executive, JLT Group. "Commercial market appetite drives captive use, sometimes just to reach the reinsurance market, as well as appropriate markets and a good understanding of risks and costs."

Christian Wertli, head of innovative risk solutions and director of corporate solutions, at Swiss Re Corporate Solutions, says captives are often set up to get direct access to reinsurance markets, and most captives have a limited amount of solvency capital and therefore rely on reinsurance for capital support. "It's all about capital, or better about solvency capital/ratio and WACC (weighted average cost of capital). Transferring tail risk to the re/insurance markets is often more cost-efficient than retaining these with the respective underlying capital, instead of just ignoring it," he says.

For Marine Charbonnier, head of A.R.T. integrated solutions, AXA Corporate Solutions, AXA XL division, it is about capital efficiency. "Captives' underwriting strategies, including the use and structure of reinsurance, are oriented to creating a capital efficient vehicle for managing and mitigating different risks."

She says they typically are based on many criteria including:

- The parent company's financial situation, as well as its strategic objectives and risk appetite
- The captive's overall financial condition including reserves/

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"The reinsurance market is a good option for the captive sector, given that reinsurers are the ultimate risk takers and specialists in catastrophe business..."

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equities, plus the impacts on regulatory ratios
- Expectations about the technical results by line of business – these obviously are more precise for lines with extensive and stable loss histories
- The overall characteristics of the portfolio, including short versus long tail and degree of correlation across different lines.

Dr Paul Wöhrmann, head of captive services EMEA, LatAm and APAC, commercial insurance, Zurich Insurance Company, says it is about the strategic use of captive, with the potential to drive arbitrage opportunities in the reinsurance market (price-wording-capacity arbitrage) by moving from a structure involving "net cession with excess insurers" to one involving "gross cession with retro panel reinsurance to captive".

REINSURANCE PROGRAMME

There are many considerations that impact the captive's reinsurance programme, according to Ciarán Healy of the Willis Towers Watson captives team, including the amount of coverage that the company needs, translated into the reinsurance limits, the capacity available in the market and the quality of the markets, all of which can impact the captive's reinsurance structure.

He notes that, depending on the type of risk and the state of the market, a panel of reinsurers may be needed to satisfy the capacity requirements, and the quality of the panel – usually judged by credit ratings – will impact the captive's counterparty default charge and therefore its capital requirements.

"However, for many captive owners, the captive fits around the risk transfer and not the other way around, so the attachment point, limits and partner requirements are of primary concern with the captive 'sitting' beneath as a deductible infill," he says. "No matter how a captive owner views the selection and setting of its captive reinsurance arrangements, ensuring consistent, 'back to back' wording is essential to avoid coverage gaps or structural issues."

> **"Most of the large reinsurers have relationships** with the captive market and many captives interact directly with the reinsurance market, bypassing the insurance players..."

He adds: "Most of the large reinsurers have relationships with the captive market and many captives interact directly with the reinsurance market, bypassing the insurance players. In fact, for some captives, finding price arbitrage between the reinsurance market and the insurance market is the raison d'etre for the captive."

Dr Wöhrmann explains that while the number of traditional insurers might become reduced and new capacity providers are entering the reinsurance and financial market, "captive owners will likely try to increasingly unlock their arbitrage opportunities". He adds: "Captives could thus be used more actively as a gate to the reinsurance and insurance-linked securities (ILS) market."

Indeed, the Marsh report notes that an increasing number of captives use ILS to access reinsurance – especially where current markets have limited capacity for the type and level of risk involved – and as a way of diversifying their reinsurance towers.

Ciarán Healy

USING THE REINSURANCE MARKET

Captives are increasingly using reinsurance in a strategic way, according to the state of the market in particular lines. According to Mr Healy: "Captives are not particularly using reinsurance to take on more risk but they are able to use the reinsurance market, because the market is soft, to take on more risk. In soft cycles or where cheap reinsurance can be bought, transfer as opposed to retention will become more attractive, reducing the amount of risk in the captive. However, the reinsurance market can open up additional or greater capacity than is available in the insurance market, which can be crucial for successful renewals."

Ms Gedge says: "Where captives are getting more sophisticated, captive owners and consultants are getting more savvy about the best risk solutions for clients, which naturally can include responding to a soft market, or accessing alternative capacity. As we see across a number of lines of business, captives are being used just to reach capacity in the reinsurance market, or access capital markets. Equally, where the commercial insurance market is offering good rates, it could be sensible that a captive reduces what it's writing itself and transfers out the risk."

Brokers explain that captives use both excess of loss/stop-loss coverage and quota share, proportionate reinsurance, or indeed a mixture of the two. Quota share is typically more common in low-frequency/high-severity risks but is still relatively common. Excess of loss/stop-loss coverage is a good structure in a captive's formative years, as it limits the amount the captive could pay and offers the parent some certainty while building comfort with the captive.

Ms Charbonnier explains that more and more captives are using reinsurance to support their strategic objectives. It tends to be facultative reinsurance but she says treaty can also be an option under certain circumstances. Captive reinsurance typically attaches at a high level, and depending on the captive's strategies, objectives and risk appetite, the limits can be either per-event or an aggregate stop-loss, she says. The former can provide capital-efficient protection against a major event or catastrophe, while the latter protects the captive from the possibility that its overall loss experience is substantially greater than expected.

Taking on US exposures

◇ UNITED STATES

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Many large European multinationals will have some degree of US-based risk, but should their Europe-domiciled captives be involved in insuring such exposures? After all, some global insurance programmes separate out US exposures and have dual programmes, largely because of the perceived greater liability exposure.

Captive managers stress that there is no reason why such exposures should not be taken on by European captives. As Ciarán Healy, of the Willis Towers Watson captives team, says: "Yes, it can be economically beneficial for Europe-domiciled captives to take on US exposures. Using a European captive can be an effective way to ensure that the risk from both geographies is managed and financed in a consistent manner."

There are certainly issues that need to be taken account, not least on the tax side, to ensure that there are strategic benefits for the captive parent. "Companies should assess the implications, cost and operational benefits of such though, including considerations such as federal excise taxes, self-procurement taxes and Base Erosion and Anti-Abuse Tax," says Rob Geraghty, international sales leader, Marsh Captive Solutions.

He says it is not yet clear what the impact on captives will be from the US Tax Cuts and Jobs Act. "On the one hand, the tax reform law may encourage organisations to pursue captives as profit centres by insuring unrelated business. On the other, the premium tax on US insurers that use foreign reinsurers may cause captive owners to reconsider their reinsurance strategies if they use offshore markets," he says.

US-DOMICILED CAPTIVE?

Another issue to consider is whether it may make sense for European groups with significant US exposures to consider the setting up of a US-domiciled captive, in addition to an existing Europe-domiciled captives. "European groups with significant US exposures could benefit from setting up a US-domiciled captive for the strategic benefits that a US captive provides, such as the potential to accelerate tax deduction on loss reserves and access to the Terrorism Risk Insurance Program Reauthorization Act of 2015 (TRIPRA)," says Mr Geraghty. Mr Healy agrees: "In most cases, the US risk in a European captive is placed locally by a fronting partner, which attracts fees and security, and so if the scale or proportion of US risk is large enough, establishment of a US-based captive may be warranted. A dual-captive strategy increases the complexity of a group's risk financing strategy, but it can be worthwhile in many scenarios."

Nuno Simao Antunes, senior vice-president, head of multinational – EMEA, AIG, says that it does sometimes happen that a company has more than one captive, typically as a result of M&As. "We have seen a rationalisation exercise in recent years, with companies reducing the number of captives that they have, but it will depend on how they have structured their risk management division. Some will be decentralised and so it may make sense to have different captives, and make use of them in different geographical locations, or different lines. It depends on the client and their risk management structure and strategy. You do see captives that are used just for US exposures, with another captive for the rest of the world. But a captive is, in most cases, by definition a global instrument and not just for one geographical area."

US EXPOSURES

As for exposures in the US being written by captives, Mr Geraghty says Marsh has seen large growth in US and global utilisation of captives for a variety of risks including cyber, employee benefits, political risk and trade credit. He says another area of strong growth in the US is high-severity risks, such as terrorism and cyberterrorism. He points out that from 2012 through 2017, Marsh-managed captives showed cumulative growth of 333% accessing international terrorism pools and 83% in coverage under TRIPRA.

He also notes that in December 2016, the US Treasury Department ruled that subject insurers that write cyber policies are included under TRIPRA, and eligible for reimbursement for losses by the federal government. "Coupled with the growing awareness of cyber threats, this has caused many businesses to reconsider their approach to managing cyber risk — including cyberterrorism — and to explore the benefits of using captives to underwrite it. Businesses often conclude that using a captive to write cyberterrorism risk is a cost-effective and relatively simple means to reduce net retained risk, especially for companies that already own captives," says Mr Geraghty.

Leveraging the power of a captive to manage and govern global employee benefits programmes

Increasing numbers of multinational businesses are using their captive reinsurance companies for managing employee benefits risk. MAXIS Global Benefits Network (MAXIS GBN) looks at the substantial benefits using a captive solution can provide to manage global benefits risks and govern the delivery of insured employee benefit programmes

◇ CAPTIVES FOR EMPLOYEE BENEFITS

Matthias Helmbold
Head, Technical and Services, MAXIS GBN

In the long term, using a captive provides the most cost-efficient solution for providing insured employee benefits (EB) to the workforce of a multinational organisation. Underwriting profits will be for the benefit of the captive, rather than for local insurers or other third-party reinsurers. Also, programmes can be structured in a way that reserves are being held centrally by the captive and premiums can be ceded upfront. This allows the captive to pool the assets required to deliver the local programmes.

RISK DIVERSIFICATION

For existing property and casualty (P&C) captives, there's also the welcome effect of risk diversification by adding employee benefits to the reinsured lines of risk. Depending on the solvency regulations of the captive's domicile, this can have a positive effect on the capital requirements.

Additionally, as many captive managers still have only little or no experience in reinsuring employee benefits, it is important to mention the high-frequency, short-tail and low-impact nature of many employee benefits lines. This allows for a good actuarial understanding of the risks held by the captive and enables the captive to control exposures.

These key benefits alone already provide a strong business case to utilise a captive for the management of insured employee benefit programmes, yet there are further advantages that may be relevant for organisations, but could easily be overlooked by risk managers.

UNDERSTANDING EB SPEND

It is important to highlight the significance for an organisation to know and understand its spend. A surprising number of multinational organisations don't have a good grasp on their overall spend on insured employee benefits programmes, let alone the trends and cost increases they are exposed to year over year. Of course, after the implementation of an employee benefits captive solution, this changes completely. In a captive, all relevant values are typically available on a quarterly basis, allowing multinationals to have the best possible ongoing monitoring and governance.

Things can even be taken a step further by linking programme renewals with the annual budgeting process of the finance function. This way, EB budgets can be directly aligned with next year's premiums, avoiding unexpected surprises for the local, regional and global finance teams. This provides better planning and certainty of the corporation's expenses.

The second aspect to consider is the change of the role the procurement function plays in sourcing local benefit programmes. As the captive centrally underwrites the plans, there's no need for local or regional procurement teams to be involved in pricing conversations. Likewise, the selection process of local insurers changes as the captive becomes a key stakeholder. This means that the primary focus of local and regional procurement and HR teams will be on the adequacy of plan designs and ensuring service levels are met.

Another significant benefit a captive solution provides is control over the terms and conditions, the design and the coverages of its programmes.

This allows for central oversight and governance, tailoring programmes to be in line with corporate strategies and the implementation of cost-control features. It also allows for the harmonisation of free cover limits by globally implementing medical underwriting requirements, balancing the captive's risk tolerance against a corporation's desire to provide insurance cover to its employees.

HEALTH PROGRAMMES

The ability to control plan designs is especially relevant with respect to health insurance programmes. Medical trends are typically far exceeding country inflation rates, with premium rates doubling in only a few years in many markets. In fact, these are the only material employee benefit programmes where costs are not directly linked to salary inflation.

Today, many organisations are heavily exposed to these rising expenses and captives can play a vital role in understanding claim trends and the driving forces behind them, as well as then exercising control over these policies rather than leaving the organisation being exposed to these ever-increasing costs.

Ultimately, the captive can be used to finance interventions that influence employee behaviours to improve the health of the workforce. This helps to lower plan utilisation, reduce trends and costs, as well as increase overall staff productivity, health and wellbeing.

To summarise, leveraging the captive infrastructure that is already in place in the majority of corporations brings great financial and non-financial benefits. With the services global benefits networks are providing to their clients, there is little reason global risk managers shouldn't explore the addition of employee benefits risk to their existing captive programme. Any corporation that wishes to globally control their spend and to efficiently govern their programmes centrally should consider a reinsurance to captive approach for their insured employee benefits plans.

Employee benefits—making the most of a captive's potential

◇ BENEFITS

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There has been much written and debated about the benefits of captives writing employee benefits business, from cost savings to better control of the benefits programme, as well as the non-correlated business providing capital efficiencies under Solvency II. An ever more internationally mobile workforce and the trend towards more central control over employee benefits mean there is huge potential for captives to write this business.

But how big an undertaking is it for a captive to start writing employee benefits business? Is it a big commitment in terms of time and effort? "There's no denying it's a big undertaking," says Damian Ross, regional manager – UK, Ireland and Nordics, Generali Employee Benefits Network. "The process of deciding whether to go down the captive route in the first place involves a considerable amount of time and effort. For a start, you need to get all stakeholders across the company – HR, finance, risk, legal, compliance and possibly the CEO – talking and in agreement."

Then there is the feasibility study. For this, he explains, you will require the assistance of a consultant and it involves gathering certain data in respect of employee benefits globally. Then you need to involve the regulator, in order to obtain a life licence for the relevant jurisdiction, and finally you would need to select a global network partner that has the necessary length and breadth of experience and reputation. He says that from initial concept to implementation, it can take a minimum of about one and a half to two years.

Matthew Latham, global head of captive programmes, XL Catlin, AXA XL division, agrees that covering employee benefits in a captive does require a significant commitment of time and effort. "Compared to traditional P&C coverages, involving a captive in employee benefits implies a significant mobilisation of the group, including in-depth coordination between the risk management and human resources teams on new and technical subjects. It also requires collecting high-quality data about employees; this can be a challenge for some big, international companies with multiple oper-ating units. These challenges notwith-standing, employee benefits prog-rammes typically have less volatility and higher premiums – that can be a net benefit for captives."

The coordination between risk management and HR is an issue, according to Nuno Simao Antunes, senior vice-president, head of multinational – EMEA, AIG: "It is still a question of establishing the bridge between human resources and risk management, and getting the dialogue going between the two departments." He adds that companies have to have a very robust and flexible solution for employees to attract and retain talent. "It can be difficult to create a global programme for employee benefits. Many companies buy employee benefits policies in each territory, and so that has to be brought together first into a global

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"These challenges notwithstanding, employee benefits programmes typically have less volatility and higher premiums – that can be a net benefit for captives..."

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programme. The market hasn't evolved in the same way or to the same extent that the P&C market has, in terms of being able to bring the global programme together."

THE PROCESS

The actual process of a captive starting to write employee benefits business involves two steps, according to Matthias Helmbold, head of technical and services at MAXIS Global Benefits Network. "First, the required licences to reinsure life risks need to be obtained from the regulator in the captive's domicile. As life risks typically require a locally licensed insurer to front the business, there are virtually no direct writing captives in the employee benefits space. The common approach would, therefore, be to establish one or several reinsurance treaties with employee benefits networks as the second step."

He says these networks will then be able to cede any employee benefits risks that are placed with the networks' fronting insurers around the world to the captive. "These networks also provide extensive services around the management of the reinsured employee benefits risks that allow captives to govern these programmes effectively," he notes.

Instead of using an employee benefits network, the captive could choose to directly implement reinsurance channels with local fronting insurers. Mr Helmbold says this is an option for very large contracts that are placed with a company that does not participate in an employee benefits network, and that the multinational company would not want to place with a network insurer. However, he explains that this is not seen as a viable approach on a broader scale as the number of reinsurance relationships that need to be managed in such a case would place a massive administrative burden on the captive.

Ciarán Healy of the Willis Towers Watson captives team says they have seen a number of approaches taken by companies to initiate an employee benefits portfolio in their captive, including:

- Providing protection on some non-insured, trust-based plans, such as medical stop-loss
- Reinsuring a large, marquee contract such as expatriate plans
- Designing and direct writing a relatively simple life or disability policy
- A fully blown, internationally fronted arrangement through the use of the multinational insurance networks.

STRUCTURING A PROGRAMME

For a wide-ranging international portfolio, the typical structure is to reinsure through a network of local fronting insurers. Mr Healy says this is due to three key reasons:

- Local insurers have the appropriate licences required to write the domestic business
- In some markets it is typical for the insurer to settle tax liabilities with regards to the insurance
- The local insurers are more than risk-bearing partners – there is an extensive service model supported for the employers but also the employees, such as communications, portals, claims payments and so on.

He explains that there are six formal international fronting networks readily reinsuring portfolios of multi-local insurances to captive structures, with more insurers also reinsuring on case-by-case arrangements.

Employee benefits risks would typically need to be placed with network insurers in the local markets in order for them to be reinsured to the captive, says Mr Helmbold. He warns that the number of employee benefits networks being used needs to be carefully chosen, as more networks mean more reinsurance relationships that need to be entertained. And he stresses that it is also important to achieve a good geographical match between the business locations of the multinational and the network's fronting insurers.

Employee benefits programmes often comprise a number of different benefits, but most are well suited to be written through a captive. Employee benefits risks are mostly short-tail, low-impact risks, with annuities obviously being an exception, says Mr Helmbold. "Pricing of these risks is well understood and they allow a captive to diversify the insured risks. With adequate protection in place, depending on the size of the captive reinsurer, the exposures in terms of high sums insured or concentration risks, captives are well suited to write all lines of employee benefits risks and can add significant value for the multinational employer for all employee benefits lines," he says.

Mr Healy points out that employee benefits insurances are a mix of lump sum, annuity and ongoing claims profiles, and the captive structure needs to understand their potential profile to ready itself for reserving and consequences of moving fronting insurers. "Traditionally, what we term as 'risk benefits' (broadly life, accident, disability) are more profitable when we assess them in the feasibility study and are often considered to promote the financing business case for inclusion in a captive structure. For medical benefits, while margins are traditionally lower than 'risk benefits', the medical trend of about 9% per annum globally shows that focus needs to be applied on understanding the underlying risk profile and looking for initiatives and change practices to improve

"Instead of using an employee benefits network, the captive could choose to directly implement reinsurance channels with local fronting insurers..."

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Steady interest in employee benefits

According to Marsh, among its managed captives, interest remains steady for writing employee benefit coverages, such as group life, multinational pooling for health and disability, and voluntary benefits such as homeowners and auto. Marsh's 2018 Captive Landscape Report: 50 Years of Risk Financing Innovation report, says interest will continue to increase in this area as rising medical costs globally remain a significant expense for organisations. Among its managed captives, 6.6% are already writing employee benefits, 15.7% are currently considering it, with 19% likely to consider it. The number of Marsh-managed captives insuring multinational pools for benefit risks has increased by 550% in the past five years, driven by the significant expense of rising medical costs.

According to Lorraine Stack, a senior vice-president with Marsh's Captive Solutions Practice: "As businesses continue to seek ways to control these rising costs, one strategy that many are using is to insure employee benefit programmes through their captive insurance companies. According to our 2018 Captive Landscape Report, in 2017 the increases in Marsh-managed captives writing employee benefits were: 35.7% for multinational pooling, 21.8% for employee benefits, and 14.3% for medical stop-loss."

She adds: "We expect continued growth in captives writing multinational employee benefits over the next three to five years. Companies are generally looking to create efficiencies and gain control as they face the triple threat of medical insurance cost inflation, an ageing workforce, and a shift in responsibility for providing benefits from governments to corporations. Human capital is an organisation's most valuable asset, and captives offer creative ways to protect it, including funding employee benefits, enhancing safety programmes, and rewarding risk-reducing behaviours."

The report explains that it can take multinational organisations a relatively long time to consolidate benefit contracts in different countries for the purpose of insuring or reinsuring them through a captive: "Generally, benefit programmes are provided to local subsidiaries and groups of employees through multiple insurers or network contracts, some of which may be multiyear. Given the increasing interest in funding employee benefits in captives, however, we expect growth to continue."

It adds that voluntary benefits, including homeowners, automobile liability, and umbrella liability, also are experiencing steep growth in Marsh-managed captives.

The report concludes: "As medical cost inflation rises worldwide, employers are seeking ways to gain control of benefit costs. Captives provide a means to create health and wellbeing programmes and collect data on employee populations to stem cost increases and improve health."

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the underlying health and modes of support from the insured."

Mr Ross adds: "Essentially, with a captive you're trying to achieve control, by taking the risk on centrally. It therefore makes sense to include as many employee benefit programmes as possible in the captive. However, there's a play-off between control and profit. So it depends on the priorities of the captive."

He explains that some aim to just break even, but they receive their data centrally and that enables them to effect good risk management practice with regards to local employee benefit programmes, which is particularly relevant to healthcare programmes. "On the other hand, some may not be as concerned about the control aspect, prioritising profit instead. These captives, therefore, have to be more selective on which contracts they take in, taking only contracts that are sustainably written and are expected to result in profit," he says.

Nuno Simao Antunes

GROWING INTEREST

So has the oft-talked about potential for captives writing employee benefits business translated into actual examples, or is it still a relatively niche area involving large captives? There does appear to be growing interest from companies around using their captives to write employee benefits.

Mr Antunes says that in terms of the intrinsic characteristics of employee benefits, it should be something that makes sense for a captive. "There is no doubt that the potential is there for continued expansion into captives. There are challenges, but it is happening – there are captives that are transacting hundreds of millions of dollars of employee benefits premium, and I can only see this market continuing to expand," he says.

There are now about 90 employee benefit captives in place globally, says Mr Ross. "This might seem like a small number but when you consider that clients need at least 5m in risk/employee benefit spend before implementing, it becomes clear that these kind of arrangements are at present being put in place by only the biggest global players. However, we see growing interest from clients."

Mr Healy concurs that there are close to 100 captives including a multinational portfolio of employee risks, with many more providing medical stop-loss or one-off arrangements. "The interest we see is higher now than it has ever been, both from established employers but also the newer high-growth businesses, and so we believe it is an area we will see material growth from in the near future," he says.

Insuring the intangible

◇ AXA XL

Marine Charbonnier
Head of A.R.T. Integrated Solutions,
AXA Corporate Solutions, AXA XL division

"That's also why more and more captive owners are implementing increasingly innovative solutions for protecting their intangible assets against various threats..."

Whether it's proprietary algorithms, massive datasets or intricate global supply chains, intangible assets are critically important sources of competitive advantage and profitability for many firms.

In fact, according to one study, intangible assets – including a company's brand, intellectual property (IP) and data – accounted for more than 85% of the S&P 500's overall value in 2015.

And just like physical assets, they need to be protected.

However, managing and mitigating the risks associated with intangible assets is complicated by the fact that they, by definition, are indistinct. Their value is subjective and often calculated using formula with assumptions about estimated future income. Moreover, their value can fluctuate widely even in the short term, the threats aren't always readily apparent, and the impacts often are hard to anticipate.

If a competitor replicated a retailer's proprietary procurement system, for example, the firm could lose one of its most significant competitive advantages. But understanding how that ultimately translates into lower sales/profitability is not easy to estimate in advance.

Likewise, when a company's systems are hacked and its data compromised, the magnitude of the loss can vary considerably. At a minimum, the damages could be limited to the ransom the hackers demand to unlock the data. However, it's also possible that publicity about the attack could seriously undermine the company's reputation and brand, leading to a steep drop in sales.

FLEXIBLE, ADAPTABLE AND CAPITAL-EFFICIENT

For a variety of reasons, the options for covering IP, data, brand and other intangible assets via traditional risk transfer solutions are often limited. Many insurers, for instance, are reluctant to cover contingent business interruption losses caused by a disruption in the supply chain.

That's also why more and more captive owners are implementing increasingly innovative solutions for protecting their intangible assets against various threats. They recognise that captives offer a flexible, adaptable and capital efficient alternative for safeguarding their reputations, IP, data and related resources.

The risk transfer options for intangible assets are limited, at least in part, by a lack of historical data as well as the inherently unpredictable nature of the risks. A captive can overcome those obstacles by bundling volatile risks where there is limited data, like a supply chain disruption or the loss of valuable IP, along with other non- or lowly correlated exposures with stable loss histories.

That enables a challenging risk, when aggregated with other perils, to become insurable at appropriate attachment points. Also, reinsurers are often willing to cover these programmes, particularly when they're part of a multi-line/multi-year contract supported by structured reinsurance. This approach offers several advantages.

First, the captive owner now has a mechanism for capturing better data about the particular risk. That data can be used to enhance its overall enterprise risk management efforts by highlighting vulnerabilities in, say, its procurement and logistics operations or its data protection systems. It also can help the captive manager and its fronting partner in refining the terms and conditions, as well as the attachment points and limits, for different risks.

Covering these risks within a captive also promotes faster, more effective responses. In many cases, when an intangible asset is at risk, speed is of the essence. That's especially true, for instance, when the company's reputation is at stake. Or as Warren Buffett famously noted: "It takes 20 years to build a reputation, and five minutes to ruin it."

However, when something triggers a wave of negative publicity, having coverage within the captive enables the company to immediately dispatch crisis management experts to limit the magnitude and duration of the damages.

A final thought. In the face of new regulations and enhanced governance requirements, using a captive to cover just a few stable and predictable lines of business is becoming less and less attractive. At the same time, many parent companies are seeing their intangible resources grow in importance and value. Both developments suggest that captive managers will continue to pursue innovative solutions that enable them to protect previously exposed assets while reducing overall risk volatility and improving capital efficiencies.

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Captives remain valid despite added scrutiny and workload brought by BEPS

◇ BEPS

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Europe's risk managers are becoming increasingly frustrated by the ever-rising volume of rules and regulations that apply to captive insurance companies, and are calling for more consistent treatment by insurance supervisors and other bodies – not least the Organisation for Economic Co-operation and Development (OECD) – to ensure the continued viability of this genuine risk management tool.

All risk managers accept that captives do need to adhere to relevant corporate governance and risk management and reporting rules. If the captive is genuinely being used to more effectively and efficiently manage and transfer parent company corporate risk, then there is nothing to hide.

But the bodies that are coming up with the rules need to recognise that captives are not corporate tax-dodging vehicles or standard commercial insurance companies writing third-party risks only, and adapt their treatment accordingly.

If they fail to do so, then the perverse negative result will be that captives will be increasingly difficult to justify and companies will lose a genuinely useful method of more effectively managing their risk, exactly the opposite of what is intended by the rulemaking bodies, agree leading European risk managers.

CONCERN OVER BEPS

For this reason, the OECD's project to tackle base erosion and profit shifting (BEPS) is a concern to all risk and insurance managers that manage captives. The Federation of European Risk

OECD, Paris

Management Associations (Ferma) not surprisingly has made this one of its key lobbying efforts under the leadership of president Jo Willaert, Agfa-Gevaert's corporate risk manager, and Ferma's campaign to dispel misperceptions about captive insurance companies is thankfully making progress.

Last June, Ferma released proposed guidelines for captive (re) insurance arrangements in order to ensure a consistent implementation of the OECD recommendations on BEPS. The guidelines are meant to support national administrations when transposing BEPS actions into their national laws.

Mr Willaert explained: "The objective of such guidelines is mainly to avoid creating a patchwork of diverging national legislations inspired by BEPS. Captives serve an important enterprise risk management role with true business purposes for European businesses and other organisations. Although captives are only a very small portion of BEPS, Ferma believes that national authorities should be guided in how to assess captive arrangements according to BEPS recommendations."

RISK MANAGEMENT TOOL

"The OECD is now aware of and recognises the role of captives as a risk management tool and the related insurance benefit for companies," said Laurent Nihoul, Ferma board member now in charge of Ferma's captive strategy and Luxembourg-based general manager of corporate risk and insurance at ArcelorMittal, in interview with *Commercial Risk Europe* late last year.

"We have established a fruitful dialogue with the tax department and the Ferma paper has been passed on to the OECD working party on transfer pricing and [its] financial transaction working group. As such, we do believe that risk managers' concerns are now fully part of the discussion.

"We invite the OECD to take into account our guidelines in future guidance documents and hope we will be able to continue our dialogue with them to support a consistent multilateral approach by national authorities…The main message from the risk management community that Ferma wants to highlight is that the contribution of captives to the financial protection of industries and the global economy should be recognised and valued appropriately by the regulators," he added.

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> **"The bodies that are coming up with the rules** need to recognise that captives are not corporate tax-dodging vehicles or standard commercial insurance companies writing third-party risks…"

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Mr Nihoul said Ferma wanted to dispel misperceptions of captives through detailed explanations about how and why they are used as risk management tools by companies. But Ferma's main objective is to promote consistency in the way BEPS principles will be applied to captives, he added.

Mr Nihoul explained: "When it comes to national regulators, we believe that our national member associations are at the right level to become the relevant stakeholders for tax authorities. Each jurisdiction may have a specific tax culture and it's important that they have a local risk management association in front of them to pursue a more detailed dialogue about the rationale of captive companies and their contribution to the economy."

FURTHER RULES UNNECESSARY

Following a detailed review, Ferma submitted its response to the publication of a public discussion draft document by the OECD, basically telling the OECD that further rules relating to captives are simply not needed.

The federation advised the OECD to refer to the IFRS 17 and the International Association of Insurance Supervisors definition of "genuine insurance transaction" and "insurable risks" as part of the guidelines. It pointed out that current insurance regulations are extremely stringent about the control of various functions of a captive such as direction, underwriting, actuarial and accounting expertise. Further indicators are not needed, Ferma argued.

"Ferma wishes for the OECD to produce final guidance that is clear and robust enough to provide multinationals with some legal certainty in terms of their captives. A further layer of regulations to be applied by national authorities could create a risk of confusion, uncertainty and ultimately more administration for multinationals and tax authorities, without providing the desired outcome for tax authorities," commented Mr Nihoul, the Ferma board member with responsibility for captives.

"When it comes to national regulators, we believe that our national member associations are at the right level to become the relevant stakeholders for tax authorities

During an interview at the recent Ferma seminar in Antwerp, Carl Leeman, chief risk officer of Belgium-based global logistics firm Katoen Natie, and Ferma board member, commented: "Indeed, there is more and more reporting and (un)necessary bureaucracy and this is the main issue for today's captive. Also, the fact that the OECD is trying to install additional rules on top of the existing ones is something we have to continue to fight/lobby against, as there is no real added value for those new rules."

CAPTIVES STILL VIABLE?

Ferma and the individual risk managers involved should be congratulated on the work that they have done and continue to do with the OECD. But the big question remains: Are Europe's risk managers comfortable that their captives will remain viable under the increasingly onerous regulatory regime and attendant costs?

Philippe Cotelle, head of insurance and risk management of Airbus Defence & Space, member of French risk management association Amrae and board member of Ferma, gave a typical response as he said that the workload clearly continues to grow but, in his view, captives still remain valid.

"All risk managers who have a captive clearly have to be compliant with the rules. The new BEPS rules will impact the way captives are organised and this will take more work, especially with reporting, to make sure that risk managers fulfil the requirements. Despite the extra workload, I believe that captives remain an excellent way to efficiently manage the risk faced by corporations and, as a community, we have to work out the best way to cope with the new rules and regulations," said Mr Cotelle.

Daniel San Millán

Sabine Desantoine, insurable risks manager at ING Belgium and president of Belgian risk management association Belrim, agreed that captives remain valid despite the rising level of paperwork, cost and time taken to comply: "I am not worried but there is certainly a need to review, check strategy, operating processes and the like to be sure the captive is in line with BEPS and other (national or not) regulations. Good contact with your national regulator and the captive's regulators is important."

Daniel San Millán, risk manager at leading Spanish conglomerate Ferrovial and founding president of Spanish corporate risk management association IGREA, said that he is not specifically worried about BEPS but does agree with his peers across Europe that compliance is tougher.

"I am not worried about BEPS specifically but overall regulations and compliance [are] becoming harder and harder," he said. For Mr San Millán and many of his peers across Europe, however, the bigger (or combined) threat to captives is actually the ongoing and seemingly endless soft insurance market.

"Generally speaking, risk managers are spending a lot more on captives to comply with the new regulatory environment; and given that the open market is so soft and shows no real signs of hardening, it will be increasingly difficult to justify the business case for captives internally. Insurers are still competing on price for the business with or without the returns needed, and this really is quite amazing and makes it difficult for captives," commented the Spanish risk manager.

Captives treatment of under Solvency II still open to question

◇ SOLVENCY II

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When the European risk manage-ment community worked out that Solvency II – Europe's capital adequacy and reporting regime for the insurance sector – would apply to captives as well as standard commercial insurance companies, alarm bells started to ring.

If the fundamental difference between captives that only write parent company risks and insurers that mass write third-party risks was not recognised by the architects of Solvency II, then European captives could be forced into extinction by unduly onerous capital and reporting requirements.

Guenter Droese, then global head of corporate insurance at Deutsche Bank and managing director of its in-house broker Deukona, mobilised fellow concerned European captive owners and formed the European Captive Insurance and Reinsurance Owners Association (ECIROA), to lobby the EC and try to persuade it to grant captives proportionally lighter treatment to recognise the difference. Ferma followed ECIROA's lead and added its weight to the campaign.

IMPLEMENTATION

Thankfully, Karel Van Hulle and his team at the EC accepted the risk management community's arguments and the principle of proportionality was formally included within Solvency II. But, as with all EC rules, there can be quite a big difference between what is stipulated at the pan-European level and how the rules are implemented at national level.

Europe's risk managers are still worried that the fundamental difference between captives and standard commercial insurance companies is not always recognised and the reporting requirements in particular are too heavy, thus adding to the workload also created by the Organisation for Economic Co-operation and Development's base erosion and profit shifting (BEPS) initiative. There is also rising frustration at the apparent inconsistency of approach among the bodies that are introducing the rules.

Carl Leeman, chief risk officer of Belgium-based global logistics firm Katoen Natie and former chairman of the federation's working group on captives summed up opinion neatly as he said: "Authorities use different reasonings towards captives: on the one hand they treat them in the same way as classic insurance companies (Solvency II), but on the other hand they treat them in a different way (BEPS). That is not acceptable."

> **"The difference between** captives and commercial insurance companies is not always recognised..."

Daniel San Millán, risk manager at leading Spanish conglomerate Ferrovial and founding President of Spanish corporate risk management association IGREA, added: "Solvency II adds more cost and is not really adding any value to business, it is just more regulation. We tried to fight the prospect of overregulation of captives via Ferma and achieved some success. Hopefully, the regulators will appreciate the fundamental difference between a captive that writes parent

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company risks only and commercial insurers and reinsurers that only write third-party business."

THE GERMAN EXPERIENCE

An example of how national regulatory approaches to captives may not be occurring in the way that risk managers want, or was intended by the architects of Solvency II, is potentially happening in Germany as the national risk and insurance management association GVNW is engaged in an ongoing discussion with national regulator BaFin on captives.

Earlier this year, GVNW's committee confirmed that it is in talks with German financial supervisory authority BaFin to try and persuade it to relax the way it regulates German captives and apply a more risk-oriented approach to proportionality under Solvency II. Frank Grund, head of the insurance department at BaFin, told *Commercial Risk Europe* in an interview that he is happy to sit down with the German risk and insurance management community and discuss how captives could be regulated on a more proportional basis under Solvency II.

Dr Grund confirmed that he met senior representatives of the GVNW in the spring, to specifically discuss the treatment of captives under Solvency II and subsequently told CRE that he is open to an ongoing dialogue.

He strongly denied that BaFin is "goldplating" the EU's insurance rules, not least Solvency II, and pointed out that the supervisory authority has dedicated a stream to captives during its annual conference in November. This is the first time captives have been granted specific attention during its event. Dr Grund said he recognises that Solvency II specifically states captives should be granted proportional treatment but pointed out that, in the absence of a dedicated German captive management community, the principle is difficult to apply.

The delegation of core management activities to professional captive managers in specialist centres such as Luxembourg means it is easier for supervisors in such jurisdictions to grant proportional treatment, he said. There is no such community of captive managers in Germany, which makes the application of proportionality more difficult, explained Dr Grund.

"We have met with GVNW and the discussion is about the principle of proportionality. We are aware that there are different approaches to this across Europe. In Luxembourg, for example, there is a dedicated captive management community. This means that the captive managers are dealing with a lot of captives and so they can be treated differently," said Dr Grund.

"In Germany, the number of captives is so small that it does not make economic sense for the captive managers to be based here. We are discussing this with GVNW and it will be interesting to see if there are ways of overcoming some of the problems faced by German-based captives. But if there is no captive manager, then it will be difficult to simplify the treatment," added the insurance supervisor.

> **"In Germany, the number of** captives is so small that it does not make economic sense for the captive managers to be based here...

"EU regulations are translated into the German national insurance law (VAG) and we stick to the rules. If written reports have to be filed every quarter, we expect it to happen. We are also looking to harmonise our approach with other countries. I accept that there are differences, but we have no interest in goldplating, no interest at all," he continued.

GVNW RESPONSE

GVNW said that it welcomes the recognition of the importance of captives by BaFin, but added that it remains concerned that German-based captives are more heavily regulated than others in Europe, particularly specialist captive centres such as Luxembourg, Malta and Dublin.

Alexander Mahnke, president of the GVNW, told delegates at its annual conference in Munich in September that he welcomed BaFin's willingness to discuss the problem. But he added that the association would like to see a firmer and clearer commitment to the application of proportionality.

In an interview with *Commercial Risk Europe*, Mr Mahnke responded specifically to Dr Grund's earlier comments: "The comment of Dr Grund in which he states that the application of the principle of proportionality for captives in Germany is dependent on an outside captive management, provides an interesting perspective. Nonetheless, we are not of this opinion and have recently stated so in a discussion between members of GVNW and BaFin.

"In our view, the principle of proportionality is linked to the complexity and risk profile of a (re) insurance entity. Unfortunately, in our experience, different standards continue to be applied in supervising captive insurers in different EU domiciles, and that should not be the case under the EU Solvency II scheme. The German captive community has actively proposed a standardisation of reporting to BaFin, in order to create efficiencies for the supervised entities and the supervisory authority alike. We will of course continue our dialogue with BaFin to further foster the understanding of the specificities of captive companies and their risk profile. A less 'legalistic' and more risk-oriented approach in supervision would definitely be welcome," he added.

As with Ferma's work on BEPS, Europe's risk managers should be grateful for the work carried out by their representative bodies and individual risk managers such as Mr Mahnke and his colleagues at GVNW, who dedicate valuable time to such efforts. While the immediate benefit of such work may not be obvious, the risk management community as a whole would find itself in an increasingly difficult position if the lobbying were left up to the insurers alone.

The role of captives in cyber risk

AIG

Nuno Simao Antunes

Senior Vice-President,
Head of Multinational – EMEA, AIG

"It is possible to use the captive as a 'risk incubator' for cyber threats by using the intelligence gained as a way to understand exposure and make informed decisions..."

Cyber liability is an issue no organisation can afford to ignore and now is the time to be thinking about whether risk transfer, retention or a combination of both is the right solution for the risks a business faces.

Cyber is no longer an emerging risk. It is a risk that is already seeing losses – AIG saw as many claims notifications in 2017 as in the previous four years combined, receiving the equivalent of one claim per working day. AIG's claims statistics show that more than a quarter of cyber claims (26%) received in 2017 had ransomware as the primary cause of loss, followed by data breach by hackers (12%).

Currently, when most think of cyber policies, it is about financial losses, fines and penalties, liabilities and loss of income, but looking ahead there are likely to be other ramifications such as property damage or bodily injury.

CAPTIVE PARTICIPATION

Given some of the confusion in the insurance market and the complexity of the risks, the benefits of retaining those risks via a captive and thereby gaining a better understanding of the losses and expenses, having greater risk oversight, and potentially reducing the overall cost of risk may be very appealing. A captive can be a useful tool to retain risk within the burn layer and to also assume broader cover not available in the traditional risk transfer market.

There are benefits to a captive's involvement, particularly when an insurance carrier fronts and shares the risk with the captive. For example, the fronting carrier may not wish to offer net capacity on a primary basis for certain risks (or industry sectors) for which the company is seeking protection. In this case, the captive could bear the primary layer of risk, thereby providing a solution that may not otherwise be available in the traditional market — or is available, but at terms that may not be viable for an insured.

Including new lines such as cyber also helps to provide greater diversity and stability for a captive. Under the provisions of Solvency II, there is an incentive for a captive owner to diversify its portfolio of exposures. Insuring cyber in the captive in addition to property and casualty creates an additional risk diversification, which may support the captive's capital requirements because the additional line is not correlated to the other business. This may have the impact of reducing the overall levels of capital that the captive needs to hold in order to maintain the minimum solvency level.

Determining how best to utilise a captive depends on the sector and the requirements of the insured; for example its exposures, where coverage is required (and available), and contractual obligations. There is no one right way of structuring the risk sharing when the risk is being fronted and then reinsured to a captive. Ultimately though, the deal needs to make sense to both parties. A captive may provide the primary layer of insurance but equally, it could also provide excess of loss, or quota share coverage depending on the market capacity restrictions applicable at the time.

RISK INCUBATOR

Applying captives to emerging risks, such as cyber, presents challenges and opportunities. When commercial insurance coverage for cyber risk is unavailable or prohibitively expensive, a captive can be used to build a statistical base, which can make securing excess coverage at acceptable terms and pricing easier. It can also be used for covers that might not be readily available in the market such as future lost revenue or first-party loss of inventory due to technology failure. It is also possible to arrange cover for highly correlated risks, such as cyber and reputation, which may not be packaged in the commercial market.

It is possible to use the captive as a 'risk incubator' for cyber threats by using the intelligence gained as a way to understand the exposure better and make more informed decisions about how to manage and finance the risk.

Captives are starting to play a role insuring cyber risk. For now, the process is gradual as cyber is a relatively new and evolving exposure for many captive owners. But as the market matures and captive owners improve their understanding of the risk, pricing becomes more predictable. As such, this is likely to drive even more interest among captive owners in addressing cyber risk through their captives.

The growth in the cyber insurance market is an opportunity for multinational clients, their brokers and carriers. What was once considered to be limited to a few markets covering risks non-admitted on a global basis, is now at a stage where locally admitted coverage is more widely available in many countries around the world. The benefits to a business of insuring its cyber risks on a controlled master policy basis with locally admitted policies covering their overseas subsidiaries, ensures compliance with local requirements and claim handling in-country, for example. Selecting a carrier with an extensive worldwide footprint is therefore an important consideration for clients and brokers.

BEPS – achieving a cost-efficient transfer pricing calculation

◇ SWISS RE CORPORATE SOLUTIONS

Thomas Keist

Head of Marketing at Swiss Re Corporate Solutions, Innovative Risk Solutions, EMEA team

"We are offering a cost-efficient answer for our clients, because the Arm's Length Pricing Quota Share covers both recommendation aspects..."

Q. What do the OECD's BEPS rules mean for multinational companies with captive subsidiaries?

A. Multinationals with captives are now facing potential penalties for failure or the perceived failure to comply with OECD recommendations aimed at preventing base erosion and profit shifting. With these recommendations, multinationals are bearing sharper scrutiny from tax authorities. It is no longer sufficient to apply Arm's Length Pricing standards. Multinationals must substantiate they have done so with model-based premium pricing and third-party quotes. And if the tax authorities discover something is amiss, they might look back a number of years in their investigation.

Q. In June 2017, FERMA has proposed "guidelines for national tax authorities". How did Swiss Re Corporate Solutions address these guidelines?

A. In evaluating what the new BEPS rules mean for captives, FERMA proposed guidelines for three key dimensions: commercial rationale, substance and governance, and transfer pricing. We specifically looked at the transfer pricing dimension and developed a compelling proposition – Arm's Length Pricing Quota Share. This is how it works: First, we use our risk assessment technology to model and quote the risk transferred into a captive programme. In the next step, we offer to participate with a quota share on the captive programme at quoted terms. There are no minimum or maximum percentage thresholds for participation. In addition, we provide a full documentation of the approach and technology used for pricing of the risk transfer.

Q. What are the advantages for the client?

A. We are offering a cost-efficient answer for our clients, because the Arm's Length Pricing Quota Share covers both recommendation aspects: a data-driven pricing service and a documentation that we deliver in a form that can easily be shared with the tax authorities – at no extra cost. Since we receive no fees and usually provide no other services, we are an independent partner – and highly credible at the same time, because we participate in the risk. A lot of companies have even been thinking of onshoring their captives to reduce BEPS risk. Instead of relocating a captive, they can opt for this service now.

Q. How has the Arm's Length Pricing Quota Share been received by clients so far?

A. Facing ever-more stringent transfer pricing requirements, there is a great demand for simple and cost-effective solutions in the market. With our Arm's Length Pricing Quota Share we are definitely striking a chord in offering a very competitive service that companies usually would have to hire consultancies or actuaries for. In the last few years, we invested heavily in state-of-the-art and data-driven pricing models. We are happy this pays off in so many ways – for us, but most importantly, for our business partners.

Q. What do you think – how will the topic evolve in the future?

A. We cannot say for sure what the future brings. It depends on the implementation of the OECD's BEPS rules – once they are final – in the different member countries. I am confident the OECD experts will thoroughly check suggested adjustments and optimisations by the different risk and captive management organisations to the latest draft rules. And I am even more confident they will adopt a majority of them moving forward.

- *Thomas Keist is the Head of Marketing at Swiss Re Corporate Solutions' Innovative Risk Solutions EMEA team. He joined Swiss Re in 1994 and held several positions in the areas of structured (re)insurance and alternative risk transfer solutions.*

- *About Swiss Re Corporate Solutions: Swiss Re Corporate Solutions provides risk transfer solutions to large and mid-sized corporations around the world. Its innovative, highly customised products and standard insurance covers are backed by its industry-leading claims service.*

The exit strategy

◇ RUN OFF

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An exit strategy is rarely high on the agenda when setting up a captive, or indeed at any point in its operation until the time comes that it needs to be closed down. A captive should be a long-term risk financing tool, so thinking about the time when it becomes surplus to requirements is rarely considered.

But generally, a captive may need to be closed down not because the captive has failed to deliver, or does not fit the risk financing needs of the parent, or because the market is so soft, or regulations or tax factors make it uneconomic. The main reason for captives being closed is mergers and acquisitions and consolidation in industry. As a result, companies may end up with more than one captive, or more captives than they need.

Whatever the reason, when a captive needs to be closed down, there are a number of options: commutation, novation, portfolio transfer, run-off, scheme of arrangement or sale. "The main consideration with a captive sale, novation, risk portfolio transfers, or any other guise, is whether it would be better to continue to run it off yourself, or whether you should move it on," says Alexandra Gedge, business development and captives executive, JLT Group. "The benefit of a straight sale of a captive is absolute finality, whilst a transfer to your re/insurers can be much more straightforward as a sale is often a long process over several months."

Clearly, what the captive parent is looking for is certainty when it comes to liabilities, but this is not easy to achieve. Run-off is a common option, as it requires little effort on the part of the captive owner. But more proactive captive owners may look at other options to provide a more immediate exit strategy. Much will depend on the type of business written by the captive. If it is largely short-tail risks such as property, then run-off may be more suitable, but with longer-term risks such as liability, the other options will tend to be a much better solution

CHALLENGE

Stuart King, president and CEO, Strategic Risk Solutions (SRS Europe), says it can be quite challenging and expensive, particularly for casualty covers. "That said, there is an active and competitive market for legacy risk buyouts and from what I have seen the pricing appears much more attractive today than in the past, but this might be less so as the global upward trend in increased interest rates continues. I certainly encourage clients at this moment to consider cleaning up a captives balance sheet whilst the market conditions are more favourable," he says.

Ms Gedge says the ease of closing down a captive depends on what lines of business are in the captive. "Practically, things like property damage have a much shorter tail than something like employers' liability (which will never end)," she says. "Fortunately, either the captive managers can run it off, or if the client wishes to remove it entirely, options such as a straight sale of liabilities or the entity are possible. I've helped with a few captive sales in the last year where the company has sold off a part of its business, but has ended up with the captive, so looked at ways to remove the risk."

As for exit strategies, she says most captives will not have a proactive, maintained plan per se, but stresses that any captive feasibility study or review should consider the exit options before setting up a captive: "Whenever I look into setting up a new captive, I always include reference to the options for the client if they were to decide that they didn't want the captive anymore."

Mr King adds: "For the vast majority of multinational captive owners, [the] captive I believe is here to stay as they are viewed as a long-term tool and have the group capital to support any volatility at the captive level. For small to medium-sized captives where their parent is not so financially strong then yes, an exit strategy or more robust capital strategy is highly recommended."

Trends in employee benefit captive programmes

◇ GENERALI EMPLOYEE BENEFITS NETWORK

Born out of market demand about two decades ago, employee benefit captives have continued to evolve in line with need. The latest iteration is seeing fronting networks, on which captives are heavily reliant, shift from reactive reporters and orchestrators of reinsurance transfer to proactive partners – helping captive clients to not only manage current risk, but also anticipate what's about to happen next.

In addition to ensuring the right policies are in the right place, at the right time, the focus of employee benefit captives is on helping clients meet their overall business objectives: mitigating costs while maximising recruitment, retention, engagement and productivity. To achieve this, fronting networks have moved from being largely reinsurance transfer vehicles and data aggregators, to developers of much more advanced risk management services.

PROACTIVE RISK MANAGEMENT

Thanks to strengthened management of local data flow and real-time global monitoring, fronting networks have expanded 'traditional' global annual reporting to now monitor local trends via quarterly drill-down reports.

This allows for a granular view on all the individual policies within a captive programme. In other words, captive clients are afforded the means to achieve an in-depth understanding of individual policy underwriting, for benchmarking or global consistency purposes. They can now make informed decision on, for example, whether to follow local market practices or investigate the modification of specific terms and conditions according to local need (such as HIV coverage, war exclusions and so on).

MEDICAL REPORTING CAPABILITIES

Today, healthcare captives are far more engaged in the health (and health delivery) of their covered populations. In line with the proactive approach already mentioned, this is a shift from payer to partner. For healthcare captives, the focus of the partnership is increasingly about addressing changes in the burden of illness for a population, which means trying to have a positive impact on the current and future health of all individuals insured.

Why is this relevant to employers? Because the rise in non-communicable diseases – more commonly known as lifestyle diseases, such as cancer, cardiovascular disease, respiratory illness and diabetes – impacts workplace populations in much the same way that it impacts society. It's one of the key drivers of 'Medical Trend', the term used to describe the forecast change in healthcare plans per capita. Additional drivers include new medical technology, new drugs and ageing populations.

Estimates of this forecast change vary dramatically from country to country, but most surveys conducted by brokers/consultants such as Aon, Mercer-Marsh and Willis Towers Watson have placed global Medical Trend at just under 10%[1] – more than three times general inflation. In other words, healthcare costs are growing disproportionately to the other costs of multinational companies.

This requires a concerted focus. While most health insurers around the globe can supply clients with summary claims data, too many report only the top ten diagnoses or general benefit utilisation. The risk is that simplistic reporting can be incomplete, one-dimensional and even distorted. Health insurers that can provide data assessment and insights deliver a better perspective: informing effective roadmaps for interventions and programmes to mitigate cost drivers.

FROM PAYER TO PARTNER

Beyond data assessment, however, in order for employers to make a real impact on employee health, it is essential to overlay claims data with observations and insights on local population health trends, programme design, provider network structure, and any impact on plan costs from the public health sector and the regulatory environment. An understanding of all of these factors is essential to help convert data into meaningful solutions for employers and those insured.

Through this approach of leveraging information to develop insight and meaningful recommendations, the best health insurers act as partners to healthcare captives – providing illuminating reports, informed and market-specific insight into cost drivers and their causes, comparative benchmark information, and targeted recommendations on how to address the findings.

WHAT DOES THE FUTURE HOLD?

Among the main trends ahead is the effort to develop not only reinsurance and reporting services but a wider range of solutions to better manage the impact of benefits plans on employees and the overall community. Again, market demand challenges fronting networks to build upon their unique access to a wealth of reliable data to define more creatively their role as insurance and service partner.

In addition to investing heavily in health data management and accompanying wellness programmes, as mentioned above, fronting networks are seeing growth in other areas too. Among the services most requested from the companies that Generali Employee Benefits works with are:

- Renewal support services, to gain better visibility and help streamline renewals management
- Consultative services, from stakeholders' dialogue, bridging the HR and risk management perspective, to benchmarking and market insight
- Opportunities for the captive to give employees access to voluntary benefits plans.

This is about applying a risk management philosophy to the employee benefits arena, ensuring that major players support and invest in creating value for their clients' overall business strategies. It's an exciting time for those ready to collaborate, embrace different perspectives and broaden their vision.

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[1] • *Medical Trends Around the World 2018, Mercer https://www.mercer.com/our-thinking/health/mercer-marsh-benefits-medical-trends-survey-2018-digital.html /*
• *2018 Global Medical Trend Rates, AON http://www.aon.com/russia/files/2018-global-medical-trends-report.pdf*
• *2018 Global Medical Trends Survey Report, Willis Towers Watson https://www.willistowerswatson.com/-/media/WTW/PDF/Insights/2017/12/2018-global-medical-trends-pulse-survey-report-wtw.pdf*

Captives preparing to write more as hard market beckons

◇ SURVEY

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For this year's report, we once again carried out an online survey of readers to take a snapshot of views on topics related to captives. The overriding conclusion of the survey is that the majority risk managers and captive owners believe a hard market is on its way, and the vast majority of respondents plan to write more business through their captive in the future.

The survey also highlights the fact that risk managers believe it is getting more difficult to justify a captive insurer, and that there is increasing pressure on captives to prove their value. One particular area is highlighted by the survey: the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting (BEPS) project. A big majority of respondents believe the BEPS rules from the OECD to be a considerable new area for potential challenges to their captive from tax authorities.

Nevertheless, virtually all captive owners see the main purpose of their captive as being to manage risk more effectively, and many are looking at new areas for their captive to play a role, such as a vehicle to reinsure employee benefits schemes.

Of the respondents to the survey, nearly two thirds (61.6%) already have a captive, while a fifth (20.5%) say they thinking about having a captive. When asked the purpose of the captive (with more than one answer possible), the vast majority (95.5%) say it was to manage risk more effectively. Other reasons for having a captive include to gain direct access to the reinsurance market (40.9%), control of the global programme (63.6%), and a reduction in insurance premium cost (54.6%).

Just 4.6% of respondents mention tax benefits as a reason, reflecting the enormous changes in how captives are viewed and used, and the tougher attitudes of tax authorities in the past few decades towards captives.

HARDENING MARKET

The survey is unequivocal on the upcoming state of the insurance market, with 59.8% of respondents believing that a hard, or hardening, market is on its way, and just 18% disagreeing (and 23% unsure) [see Figure 1]. Respondents' comments include: "The bottom of the price-level has been reached. Flat or increase of pricing has to be expected"; "The business model of insurers is changing, premium is no longer sufficient to cover risks"; and "It has to turn at some point..."

Others are less sure: "Hard to read the market at this time. Historical fundamentals say yes; observations say no"; "Certain pockets are certainly showing signs of hardening but it will not be seen across the board"; and "Will probably depend on the evolution of interest rates. As long as they stay low, I do not foresee a hardening market except for some coverages such as storm in the US, or flooding in general."

Others stress that it will depend on the amount of alternative capital available and its use, while one respondent says: "There are new developments in the world on a daily basis, thereby resulting in new and technical innovations and increasing a competitive and tight market."

When asked if there are there signs of hardening in any classes/regions, two thirds (66.7%) agree, with many highlighting property classes (especially on the cat side and in the US), financial industries and financial lines, especially D&O, and professional indemnity (especially UK solicitors and construction).

One respondent points specifically to property (UK, Europe), D&O (Europe, UK, US), and automotive (Europe), while another highlights financial lines, in particular D&O: "Side C coverages in Australia show a material hardening as a result of the increased litigiousness introduced by litigation funds."

> **"The result of this concern over a hardening** market, either across the board or in regional or class pockets, means that the vast majority of respondents are preparing to use their captive to greater effect in the future..."

The result of this concern over a hardening market, either across the board or in regional or class pockets, means that the vast majority of respondents are preparing to use their captive to greater effect in the future. A massive 86.4% of respondents say that they plan to write more business through their captive in the future, with just 4.6% planning to write less, and none looking to

Online Survey

Figure 1:
Do you think a hard, or hardening, market is on its way?

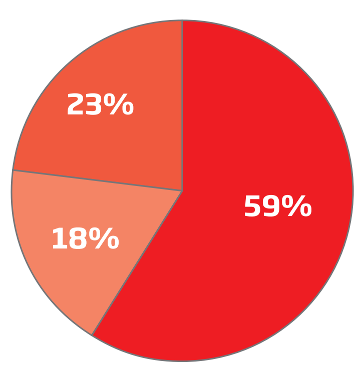


Figure 3:
Is there more pressure on captives to prove their value?

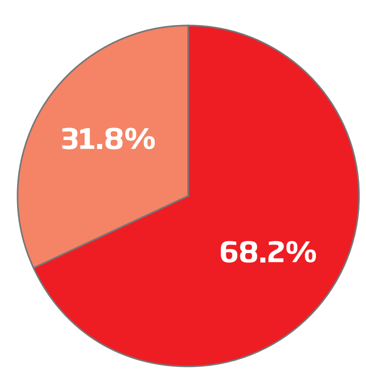


Figure 5:
Do you consider the BEPS rules from the OECD to be a considerable new area for potential challenges to your captive from tax authorities?

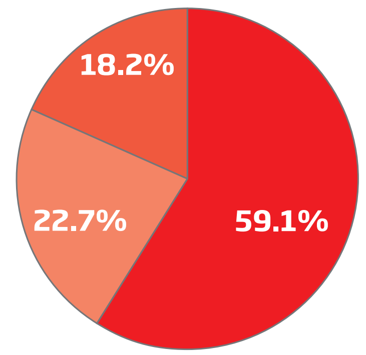
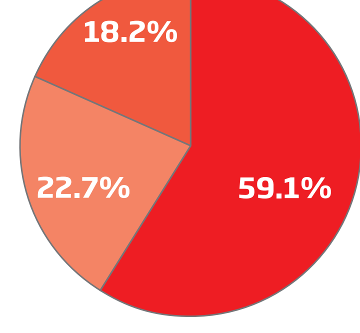



Figure 2:
Do you plan to write more business through your captive in the future?

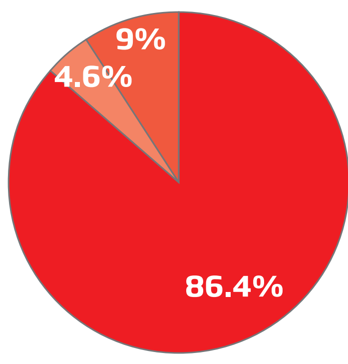


Figure 4:
Do you use your captive and its pricing of insurance to as a risk management tool for rewarding/penalising good risk management practices in subsidiaries?

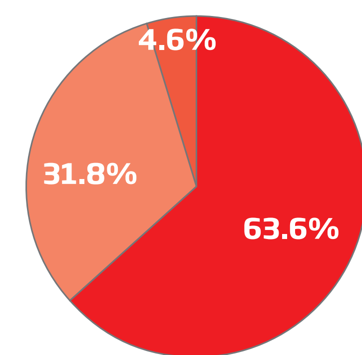


Figure 6:
Do you envisage use of the captive as a vehicle to reinsure your employee benefits schemes?

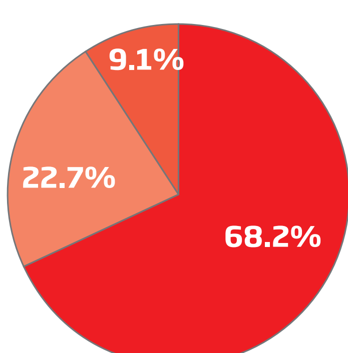
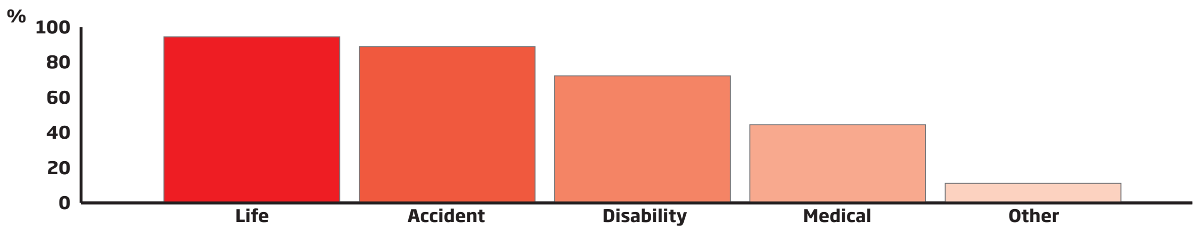


Figure 7:
What benefits among life, accident, disability, medical would you write/cover?



27

write the same amount [see Figure 2].

Interestingly, two years ago when we carried out a similar survey, just 34.3% said that they intended to use the captive more in the near future, with 45.7% saying that they planned to use their captive the same. Clearly, the threat of a hardening market, together with pressure to make better use of the captive (to justify it to the board) and the rise of new and emerging risks, has altered the view of captive owners towards their captives.

PROVING THE VALUE

Certainly, it would appear to be getting harder for risk managers to justify a captive insurer. According to the survey, more than two thirds (68.2%) say it is harder than it used to be to justify a captive insurer, while just over a quarter (27.3%) say it is about the same as it used to be, with 4.5% unsure, and no one saying it is easier than it used to be. This compares to last year's survey, which found that 50% said it was getting harder for risk managers to justify a captive insurer. Respondents this year point to stricter rules and compliance regulations making it harder to establish a captive.

And more than two thirds (68.2%) say there is more pressure on captives to prove their value, with 31.8% disagreeing [Figure 3]. Respondents note that this has always been an issue, but current pressures include a greater focus on the cost of capital, pressure to support the business case, and in particular from international bodies such as the OECD.

Captives continue to be used as a risk management tool, in particular its pricing of insurance, for rewarding good risk management practices in subsidiaries, or penalising poor practices. Nearly two thirds (63.6%) of captives are used in the this way, almost exactly the same percentage as last year. [Figure 4]. On the issue of using a captive to 'incubate' difficult emerging risks such as cyber, the survey reveals that 50.1% do so, or plan to in the near future, with 45.4% not planning to.

> **"There are always challenges and opportunities** for captives, but history has shown the captive's ability to meet challenges and take on the opportunities wherever they are presented

CHALLENGES AND OPPORTUNITIES

There are always challenges and opportunities for captives, but history has shown the captive's ability to meet challenges and take on the opportunities wherever they are presented. One of the great advantages of the captive as a risk financing tool has been its flexibility, and the ability of the sector to come up with innovations and new types of vehicle, in order to remain relevant and cutting edge.

During the past few years, the BEPS rules from the OECD have caused considerable grief for the captive sector, especially because of the uncertainty in the early days. The challenge of BEPS has not gone away, and has meant that captives have had to ensure that they adapt and face up to the challenge from BEPS, in terms of transparency, a focus on the risk management elements, and a concerted effort to highlight exactly what captives are and their purpose and value to parents in terms of risk management.

This year, the survey asks if captive owners consider the BEPS rules from the OECD to be a considerable new area for potential challenges to their captive from tax authorities. It finds that 59.1% agree it is a new area for potential challenges, with 22.7% disagreeing, and 18.2% unsure [Figure 5]. Last year, 55.6% said that BEPS had increased the administrative time and costs of running their captive (with just 19.4% saying it had not), while in 2016 just 23.7% said that BEPS and the related tax evasion initiatives underway were likely to have a 'considerable' effect on the captive market, with 38.2% saying that they would have a 'slight' effect (and only 11.3% predicting that BEPS would have no effect on the market).

One area that is seen as an opportunity for the captive sector is in the field of employee benefits. Indeed, the benefits of using a captive to write this line of business have been set out elsewhere in this report, and in the last two Captive Reports from Commercial Risk. Not just in terms of the captive being a perfect vehicle for reinsuring pools, but also the diversification benefits that writing life business in a captive can bring (and the impact on required solvency levels).

But are captive owners aware of these benefits and opportunities? The survey suggests that the message is getting across. When asked: "Do you envisage use of the captive as a vehicle to reinsure your Employee Benefits Schemes?", more than two thirds (68.2%) say yes, compared to just 22.7% who say they do not, and 9.1% who answer "Not sure/maybe" [Figure 6].

Last year, the survey revealed that 58.8% of respondents had consolidated life and non-life risks in their captive (or were considering this), compared to 32.4% who had not.

This year, the survey delves further into the issue, asking that if they did envisage using the captive as a vehicle to reinsure employee benefits schemes, what benefits among life, accident, disability, medical would captive owners write/cover? It reveals that 94.4% would cover life, 88.9% would cover accident, 72.2% disability, 44.4% medical, and 11.1% other, (including workers' compensation) [Figure 7].

Captive domicile roundup

◇ DOMICILES

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The number of captive domiciles continues to grow, largely driven by the US where states are still queuing up to pass captive legislation. As for the captive market, it is still seeing hundreds of new formations every year, currently matched by hundreds of closures. Formations are strongest in the US and particularly small captives, while M&As are driving captive closures. Marsh notes that consolidation due to merger and acquisition activity is partially behind the reductions and flat growth in the number of captives in North America and Europe in the last few years. Long gone are the days of groups having a whole handful of captives.

CAPTIVE FIGURES

For non-US-headquartered companies, the main domiciles are still the traditional ones: Dublin, Guernsey, Luxembourg, Isle of Man, Singapore and of course Bermuda. Then there are newer and smaller domiciles such as Labuan, Malta, Hong King and Gibraltar.

In 2017, the Bermuda Monetary Authority (BMA) issued 17 licences to captives, to give a total of 739 active captive licences at the end of the year, compared to 776 active captive licences at the end of 2016. Bermuda captives wrote $54.7bn in net premiums in 2017.

The BMA said the new 2017 captives covered a diverse range of risks, particularly among the Class 1 captives, which included Canadian conglomerates writing general liability and workers compensation, and US healthcare captives insuring nursing homes and medical stop-loss cover for employees.

Guernsey saw nine new captives including one protected cell company (PCC) and one incorporated cell company (ICC). It also saw 67 new PCC cells and eight new ICC cells. At the end of 2017, there were 315 captives (including 61 PCCs and 15 ICCs), compared to 321 at the end of 2016. There were 486 PCC cells and 52 ICC cells at the end of last year. Premiums totalled £5.48bn at the end of 2016, and gross nominal assets £28.75bn.

Guernsey Finance said the Guernsey insurance industry has been considering establishing entities that combine insurance and investment activity in one vehicle.

Dublin saw two captives authorised in 2017/2018. At the end of 2017, there were 79 captives – 51 insurance and 28 reinsurance. Gross written premium totalled €1.45bn in 2017, with nearly half coming as a result of Freedom of Services in the EU.

> **“For non-US-companies,** the main domiciles are still the traditional ones: Dublin, Guernsey, Luxembourg, Isle of Man, Singapore and of course Bermuda...”

Malta reports that the number of captive licences at the end of 2017 was eight pure captives and 14 PCCs (34 cells). Ian-Edward Stafrace, chief risk and compliance officer and executive committee member of Atlas Insurance PCC, says: “The uncertainty behind Brexit, particularly on what market access UK and Gibraltar will be granted, is an opportunity for Malta to provide support and solutions. In the medium term, Malta will likely be the only member of the EU single market with insurance protected cell legislation. Should a hard Brexit become a reality, companies could maintain direct access to 30 member states of the EEA through Maltese cells.”

ASIA-PACIFIC

Marsh says that the Asia-Pacific region, however, has shown consistent year-over-year growth, including a 24% increase in 2017 in the number of Marsh-managed captives, driven by parents based in Japan, China, Hong Kong and Singapore.

The Labuan International Business and Financial Centre saw the number of captive licences issued increase to 43 in 2017, from 39 in the previous year. The total number of insurance-related licences fell from 204 to 203. Gross written premiums for captives totalled $361m.

Hong Kong is a new and currently small player in the captive market. But many believe it will become an important centre for Chinese-parented captives. Hong Kong is bringing in tax concessions to further develop the territory as a captive domicile. It is looking to boost its position as an insurance and risk management hub, especially with the opportunities arising from the Belt and Road Initiative.

Carrie Lam, chief executive, Hong Kong Special Administrative Region Government, said her government has been working very closely with the Hong Kong Insurance Authority to enable the development of captive insurance, marine insurance and the underwriting of specialty risks in Hong Kong. “We are now considering new tax incentives to fast-track these lines of insurance, together with measures to promote the issuance in Hong Kong of such insurance-linked securities as catastrophe bonds. These and other measures are sure to boost Hong Kong’s status as an insurance hub and risk management centre, and will surely help us seize the boundless opportunities arising from the Belt and Road Initiative,” she said.

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