CAPTIVES IN A HARD MARKET

Paul Woehrmann and Pieter Nyssen from Zurich analyse the range of alternative risk transfer solutions in the current hard market

Another busy renewal season has passed by. As the dust is now settling, it is good to look back for a short while and share some reflections on how captive owners (re-)acted on the continuing hard-market environment[1].

Since the arrival of the hard market, different exposures created new and diverse challenges for companies and brokers. Capacity gradually decreased, premium rates went up and conditions became more stringent. In the beginning, primarily property risks were impacted. Finding sufficient capacity at pricing levels acceptable to them was sometimes quite challenging for customers, especially in respect of business interruption and contingent business interruption.

In recent years, the effects of the hardening market continued in property but also expanded to other risks such as cyber, D&O and professional indemnity. In cyber, two years ago, carriers could each provide easily €10m in capacity, whereas nowadays €5m seems in many cases to be the maximum available. This, in combination with an increased demand for higher cyber limits, makes it quite hard for companies to find the required or desired level of capacity. In such a situation, companies are faced with the choice of accepting the terms and conditions available in the market or to look for alternative solutions by retaining all or part of the risks themselves.

One of the alternative options for companies is to bear more risk themselves by way of self-insured retentions (SIR). Although a valid option, it has the downside that in case of a large loss, it could create a heavy financial burden on the smaller local operational entities of the company. Those entities may not have the financial strength to absorb such a loss and could therefore be obliged to reach out to the parent company for financial support.

A more practical and more beneficial alternative could be to use a captive or other alternative risk transfer solutions to manage these retentions in a more efficient way. The involvement of such alternative risk transfer solutions would allow the local operational entities to remain insured with a deductible adapted to their needs while the large retentions are taken at group level.

Following the recent renewal cycle, one

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could wonder whether companies and captive managers are adopting the same logic and are increasing the use of the captive. In an article[2] published in *Captive Review* last year, Zurich's internal analysis and external survey seemed to indicate that captive owners in the past were reluctant to make frequent adjustments to the level of risk they bear. Now, it appears that, under current market conditions, the buying behaviour of captive owners is gradually changing towards more increased levels of risks ceded into the captive. Based on our observations, there are different ways and different levels through which captive retentions are being increased.

First, on the level of a primary layer, we observed that many captive owners raised their captive retention by increasing the per occurrence limit and/or the annual aggregate limit. By doing so, they not only obtained better control on the pricing of this high-premium-driven layer, but it also allowed the insurance market to attach at a higher level.

The benefit of such a higher attachment point on layers above the captive layer is two-fold. On one hand, it potentially generates a reduction and/or stabilisation of the premiums paid to the insurance market for that excess layer. It could also create more appetite from the insurance market to deploy extra capacity in such a layer with a higher attachment point. This way, a captive owner can optimise the available market capacity by letting the insurers attach at a level where the market is more comfortable and willing to provide the necessary capacity.

Besides increasing the limits retained by the captive, captive owners were also looking into ceding some specific coverages/risks into their captive (eg contingent business interruption and US windstorm in property or dependent business interruption in cyber) for which there was apparently not sufficient capacity available in the market or for which the premium was perceived to be too high compared to their own assessments.

The hard market also impacted the scope of the coverages itself. For example, coverage for D&O, professional indemnity and cyber got more restricted with the introduction of new and/or lower sub-limits or with exclusions being added.

Although those restrictions could in most cases be absorbed by the company at group level, some of these changes could still have a significant impact on the operational entities of the group. Some of the smaller ones may not always have the financial strength to assume those risks. In order to protect the local entities, some captive owners considered to take on exclusion buy-backs or to top up sub-limits by ceding them into the captive. By doing so through its captive, the company could provide its operational entities the coverage and limits needed, suitable and geared for their local operations.

Not only was the effect of the hard market noticeable on the primary layers, but the excess layers were impacted as well. We observed in the market that captives were deploying capacity on (lower) excess layers to fill in the gaps caused by lack of capacity in the market. We even observed risk managers taking the decision, even on fully placed layers, to still replace part of the capacity (which they believed to be too expensive) by a participation of the captive.

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The premium level for that captive participation becomes more in line with the company's own pricing expectation on that layer. This captive strategy does not only reduce the overall cost of risk for that specific layer. It also facilitates the placing and pricing of the tower built on top of that layer given that the layer beneath is placed at 100% and at more moderated rates than if the captive had not participated.

Although these are the general trends observed on how companies (re-)acted on the continued hard-market environment, the direction and decisions taken by an individual company and its captive owner is ultimately driven by their specific needs, their willingness to take risks and their financial capability to do so.

For companies that remained financially strong and cash-rich throughout the pandemic, investing in the captive will be an easier process than for companies in a less financially comfortable position. For them, it might be much more of a challenge and a longer process to convince their senior management to invest in a captive.

So far, we witnessed that, on average, the additional capacity ceded into the captive remained moderate and did not as such require a complete overhaul of the captive strategy and structure. Apart from some exceptions, generally the increase of captive retention remained at such a level that no capital injection for the captive was required. That gives the risk manager or captive owner the benefit of implementing the changes in retentions faster, without the need to go through the potentially long and cumbersome process of obtaining executive approval to increase the captive's capital.

Going forward, should the hard market continue, it is not unlikely that companies and captive owners will be forced to take more drastic decisions on raising captive retentions at much higher levels, which then may require additional capital in the captive.

Holger Kraus, head of the captive committee of the German risk and insurance managers' association (GVNW) has commented: "In doing so it is important to analyse all relevant effects of such a decision, eg the compatibility with the risk bearing capacity of the captive or the effects of the increased retention on the P&L and balance sheet of the captive's parent company in case of an adverse claims situation. Thus identifying and involving all relevant stakeholders at an early stage is a useful exercise."

Furthermore, we have observed another interesting development in the last year, namely that large European mid-sized companies, which do not have the critical size for an own captive, appear to be increasingly interested to use the flexibility of the captive concept. Here, both the international pooling of local retentions into a group retention across different lines of business plays a significant role as well as the existing possibility of gaining direct access to the reinsurance market and alternative markets in addition to the primary insurance market.

Derek Bridgeman, managing director of Strategic Risk Solutions (Europe) also observed this development by stating: "Over the past 18-24 months, they have continued to experience an increased demand around the evaluation and utilisation of protected cell captives (PCC). Shorter implementation times and lower cost and resource requirements, when compared with a wholly owned structure are obvious drivers of this increased interest.

The hard market has often resulted in substantially higher premiums and deductibles being enforced on corporates by the market, which in turn has resulted in more mid-sized corporates having the critical mass necessary to justify a formalised approach to risk retention such as a captive or cell. The inability to obtain cover at an economically acceptable price in the market has resulted in risk managers seeking alternatives to the traditional insurance placement, particularly for risks such as professional lines, cyber, and property and casualty."

Timothy Powel, head of financial lines and cyber of Zurich Insurance in the UK, predicts that companies interested in insurance coverage will generally have to accept a larger deductible on new cyber policies or policies up for renewal[3]. Captive owners could incorporate such requirements into an existing captive risk financing plan. For large mid-sized companies, a cross border pooling strategy for an international programme could possibly be based on the PCC concepts established in the market or on the 'virtual captive solutions' that have been mentioned more frequently as of recently.

These instruments certainly represent a broadening of the spectrum of alternative risk financing solutions. Virtual captives are understood by market participants as contractual solutions replicating the effects of a captive for multi-year insurance programmes by way of a bonus-malus system that serves to provide for risk and reduce the volatility caused by major loss events in a company's income statement[4].

These have been seen in the market as both monoline and multiline solutions. Policyholders are advised to consider upfront the handling and the effects of contract terminations with possible profit sharing in such contracts. It will be interesting to see how the spectrum of alternative risk financing solutions develops in the present market environment.

In Q4 of last year, we have experienced that several large captive owners decided to double their captive retention. This development could possibly continue in Europe in 2022.

[1] These observations are in line with what was already shared in a panel discussion at the European Captive Forum in Luxembourg: *Hardening markets – Limits of Insurability: Captives in a Hard Market*, panel discussion with Udo Kappes, Holger Kraus, Derek Bridgeman and Pieter Nyssen - European Captive Forum 2021 – Luxembourg, November 10, 2021.

[2] *The Continued Rise of Captives* by Paul Woehrmann, Christoph Betz and Roopesh Davda in *Captive Review* – November 22, 2021

[3] Thomas Hengartner: *Cybergefahren sind eine grosse Chance, in Finanz und Wirtschaft* v 29.1.2022, Nr. 8, S. 8

[4] Robert Makelaar und Peter Reichard: *Virtuelle Captives: das Beste aus beiden Welten, in Versicherungsmonitor*, 5. Januar 2022