Artex

THE RISK-INTELLIGENT CAPTIVE

Key focus points from 'Insuring the Future', a UK roundtable discussion hosted by Artex and Airmic.

In association with

airmic

OVERVIEW:

- As capacity becomes restricted for complex risks, captives are filling the gaps left by the traditional insurance market.
- Corporates are increasingly recognising the additional benefits of captives, such as using their captive as a risk incubator — both demonstrating confidence in their risks to the insurance market and differentiating them from those of their peers.
- Captives are moving away from simply being a solution for an organisation's predictable, 'vanilla' risks and are increasingly used for high-severity, low-frequency risks.
- Organisations are using captives strategically to manage their risk, no longer viewing them as just a 'harder market' solution.

In recent years, the hardening commercial insurance market has prompted captive owners to get more from their risk retention vehicles. It has also seen a growing number of corporations consider captive insurance for the first time as well as driving significant innovation within the alternative risk transfer solutions arena.

While captives were traditionally used for a parent company's more 'vanilla' risks, this is changing. As the risk landscape becomes more intangible, with less capacity for more complex risks within the commercial insurance market, captives are proving a natural home for some of these.

For political risk and cyber, for instance, the parent company is often better placed to understand some of their exposures and take concrete steps to mitigate them. Other benefits include the captive being used as a risk incubator and offering more confidence to insurance and reinsurance partners that these risks are being actively managed and are therefore better than their peers.

This whitepaper considers the evolution of the risk-intelligent captive and draws on the highlights from the 'Insuring the Future' roundtable discussion hosted by Artex and Airmic in November 2023. It will explore how captive owners can open up their risk retention vehicles to more complex risks, what steps they can take to mitigate some of the more extreme risk scenarios, and the innovative solutions and partnerships that can be achieved.

THE NOT-SO-ALTERNATIVE RISK TRANSFER

According to EY's 2024 Global Insurance Outlook report, captives now represent nearly 25% of the overall commercial insurance market and almost every Fortune 500 firm owns and operates its own captive insurer.[1]

"

There was a time when captive insurance was largely a solution for financing an organisation's more 'vanilla' risks. In line with growing sophistication around risk controls and risk management, it makes sense that captive owners are keen to take a more proactive stance in financing their more volatile exposures.

— Paul Eaton
Chief Executive Officer
Artex EMEA

PART ONE:

REIMAGINING CAPTIVES — CHOICE OR NECESSITY?

The commercial insurance market continues to experience challenging conditions against a backdrop of multiple macroeconomic and geopolitical risks. Capacity restraints, exclusions, and a reduced appetite for certain risks have led to claims inflation and higher premiums. This has forced many organisations to reassess their attitude towards risk and ways to manage it more effectively and efficiently. This is particularly true for emerging and evolving risks, such as cyber and geopolitics, which are harder to predict.

Captives are breaking their own mould

Typically, the state of the insurance market would dictate an organisation's captive usage, with hardening market conditions tending to result in more risk being retained on the balance sheet. While captives have traditionally been used for high-frequency, low-severity risks, attitudes are changing as organisations find it increasingly challenging to find what they need from the traditional insurance market.

Increasingly, organisations are bucking the trend and turning to captives to insure their more complex risks — in other words, risks considered low frequency but high value. Data, analytics, and risk insights are key in these scenarios because it is difficult to know exactly when these types of events are going to occur and how significant their impact will be.

Recent statistics from EY's Global Insurance Outlook report[1] demonstrate that captives are now considered less as an alternative risk transfer solution and more as a mainstream source of capital. They are expanding to encompass greater diversity of growth and lines of business, sometimes through choice and sometimes through necessity due to higher price points, more restrictive coverage, and/or lack of available capacity in the traditional insurance market.

[1]Santenac, Isabelle et al. "2024 Global Insurance Outlook," EY, PDF file.

CASE STUDY

SMART CYBER INSURANCE: RISK MANAGEMENT IN REAL TIME

The challenge

Cyber risk is a rapidly evolving exposure. Insurers in the commercial insurance market have a limited understanding of — and therefore little appetite for — operational technology and AI risks in terms of cybersecurity. This is resulting in reduced capacity for cyber insurance.

The solution

- A shift from the classic insurance route and a move towards a 'live' process of risk management can make cyber risks more suitable to be retained in a captive.
- Regular vulnerability scanning can help identify issues before they become major problems, helping organisations, and captive owners avoid attacks and reduce their probable maximum loss (PML).
- Parametric risk management, such as using a sensor on a remote network, can be harnessed to detect unexpected changes/anomalies in real time.

The benefits

- While the estimated maximum loss (EML) is still the same, the PML is reduced through proactive cyber risk management.
- Better understanding leads to better control, particularly regarding rapidly evolving exposures such as cyber.
- Continuous cyber risk management is looked upon favourably by insurers.

> “
>
> **For cyber risk, there needs to be consulting around the process — moving away from the classic insurance form and towards a 'live' process of risk management.**
>
> — Johnty Mongan, Global Head of Cyber Risk Management, Gallagher

UTILISE THE SERVICES AVAILABLE FOR STRUCTURED SELF-INSURANCE

To get the most from your captive, it is important to tap into the knowledge and services of risk management consultants. Working alongside specialists in this type of risk financing can help you continuously evaluate exposures and actively underwrite more dynamic risks.

You should also ensure that the key stakeholders in your company are aware of the captive and its purpose — from Chief Information Security Officers (CISOs), security teams, supply chain managers, procurement, through to HR — if you choose to place employee benefits risk into the captive. Risk managers that build this partnership approach into their strategy tend to find their captives to be more creative and flexible solutions with the capacity to insure more risks.

"

Captives are way more effective and sophisticated and more valuable when companies involve all the important stakeholders in the strategy.

— Richard Cutcher, Captive Ambassador, Airmic

PART TWO:

A CRITICAL HUB IN THE INSURANCE VALUE CHAIN

The risk-intelligent captive is becoming the central hub that houses all the information about the captive owner's risk profile. It helps the owner understand which risks to transfer, what the price of those risks should be, and the level of risk appetite.

The captive can bring the following benefits as a central risk management vehicle:

Influences on insurance buying: For large companies and sophisticated insurance buyers, the captive has taken the role of the central risk management vehicle and can help determine insurance buying decisions.

An always-on approach to data: A risk-intelligent captive takes a proactive approach to risk-based analytics. This helps to ensure the captive will always be equipped with the data and the knowledge to accept the appropriate level of risk, whether or not the commercial insurance market is experiencing a soft or hard cycle.

Helps build a claims history: Captive incubation allows parent companies to build up a claims history and develop a detailed understanding of their risk profile and vulnerabilities.

Boosts underwriting profitability: When risk quality continuously improves, it can further boost your captive's underwriting profitability and risk marketability. Underwriting profits can be transferred back to the captive owner as a dividend or help build up the capital and surplus, allowing the captive to take on more risk.

Helps negotiate more favourable terms within the tower: If the insurance market knows you are self-insuring via a captive, it will be more confident in your risk and more willing to engage. In a more challenging market, if the captive is taking more risk, particularly in the lower layers (and therefore pushing the commercial market further away from the potential for attritional losses), there is a greater likelihood of favourable terms from insurers, such as having exclusions written back into policies.

> Businesses are looking beyond the 'bread-and-butter' captives. Captive structures are becoming increasingly sophisticated and sustainable in delivering cost, risk management, control, and coverage benefits to their owners.
>
> — Julia Graham, CEO, Airmic

The potential to build a diversified book of business: The more diversification you have in your captive, the more efficient the captive becomes. For example, suppose you have Property and Casualty (P&C) risk in the captive and also include employee benefits risk or cyber risk. In that case, it offers a diversification benefit because these types of risks are not normally correlated. This can lead to a more efficient use of capital.

Risk bursaries for extra resilience to shocks: Risk bursaries tend to be more difficult to obtain in harder market conditions, and this is where a captive can be useful. It can be used to pay for risk bursaries, essentially giving the parent company a budget for risk modelling or investment in additional risk management measures. This can help mitigate losses and improve the risk profile of the company. It is looked upon as a worthwhile investment because it will likely reduce the underlying risk.

Management of long-tail risks: As a long-term risk financing and risk management strategy, a captive can spread the funding of losses across multiple financial years. In this way, it can help the captive owner build up a 'war chest' over time to help protect the parent company.

CASE STUDY

POLITICAL UNREST: SPOTTING THE RED FLAGS

The challenge

Geopolitical risks are typically viewed as unpredictable and difficult to manage, and political violence and unrest can seemingly arise from nowhere. Events over the past few years — including uprisings in Chile and Hong Kong — have shown how quickly situations can change, even in seemingly stable regions. As such, insurance policies commonly contain exclusions for SRCC (strikes, riots, and civil commotion), and the cost and availability of specialist political violence coverage have made it more difficult to secure cover. There is currently limited appetite for parametric solutions in this area of insurance, largely because the triggers are difficult to predict and define.

The solution

Risk management and risk transfer can be better connected through a combination of specialist risk management consulting and captives.

Consulting and translation: Working with specialist consultants to identify red flags can allow corporations to respond proactively to certain events before they unfold. It offers real-time rating and the continuous assessment of risks using data.

Captive deployment: Captives can be used to write back in certain policy exclusions and to demonstrate 'skin in the game' and an alignment of stakeholder interests.

The benefits

- Continuous monitoring of an organisation's global footprint in relation to the political risk landscape.
- Captives can contain tailored wording all the way up the insurance tower, with support from an intelligence perspective.
- Captives bring more control, allowing you to build claims management into the structure from day one.
- Organisations can control pricing and underwriting themselves. If you know more about your risk than the markets do, you can better price it. Actuaries can model your risk using the data.
- Demonstrates to insurers greater confidence in organisational risk management.

"

The continuous assessment of risks using real-time data can help you know more about your risk than the markets do, enabling you to better price it.

— Jake Hernandez
CEO, AnotherDay
(A Gallagher Company)

CASE STUDY

RISING SEA LEVELS: MANAGING STORM SURGE RISK

The challenge

In recent years, the increasing frequency and impact of extreme weather events have been seen globally. A study by the Gallagher Research Centre and flood risk specialists, HR Wallingford, on UK storm surge showed the high uncertainty involved in characterising coastal flood risk. The study highlighted the large uncertainties involved in flood defence modelling and how climate change is driving rising sea levels and an increasingly exposed coastal population. The study also showed how UK storm surge events tend to cluster over particular winter seasons (e.g., 2013/2014), creating a greater risk of aggregate losses.[2]

Often described as sub-perils or secondary perils, floods, wildfires, and severe convective storms are now a major driver of loss. Currently, UK commercial properties are not covered by Flood Re.

The solution

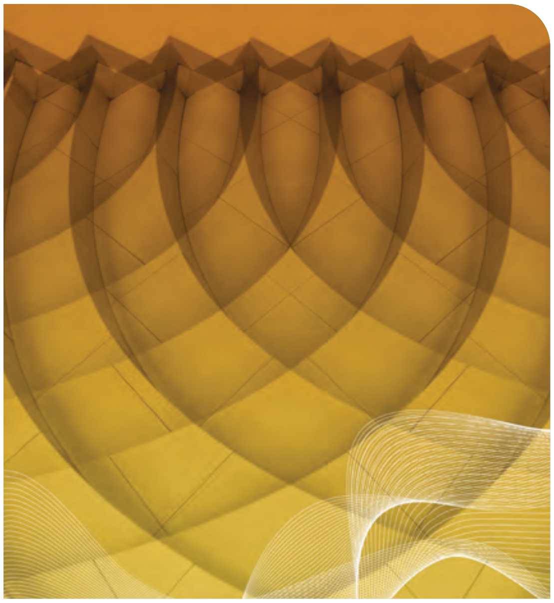
- Corporates and captive owners should factor these changing exposures into managing and pricing the risk.
- Investments in resilience, such as sea defences, should be made with the notion of 'building back better' rather than simply reinstating what has been lost or damaged.

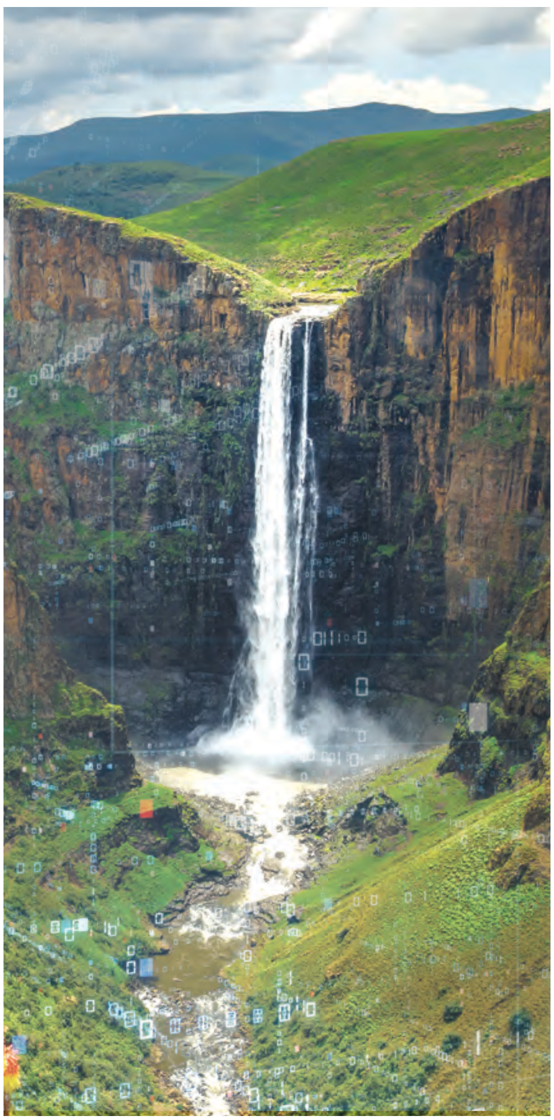
The benefits

- Captive layers offer the opportunity to control pricing all the way up the insurance tower.
- Corporates can have more control over how much risk they retain in the captive and how much they spend in the insurance market.
- It gives corporations more control and stability when commercial insurance pricing is hardening, and capacity is constrained.
- Creative use of a captive can lower the total cost of risk.

> Storm risk in the UK is increasing, but risk management is rising to meet the challenge through advanced risk modelling and credible data.
>
> — Iain Willis, Research Director, Gallagher Research Centre

[2]Gallagher Re, "New Storm Surge Scenarios Developed for UK Insurers," 9 August 2023.





“

Cyber threats, political risks, natural catastrophe events… these represent a window into the types of risks captives are increasingly addressing.

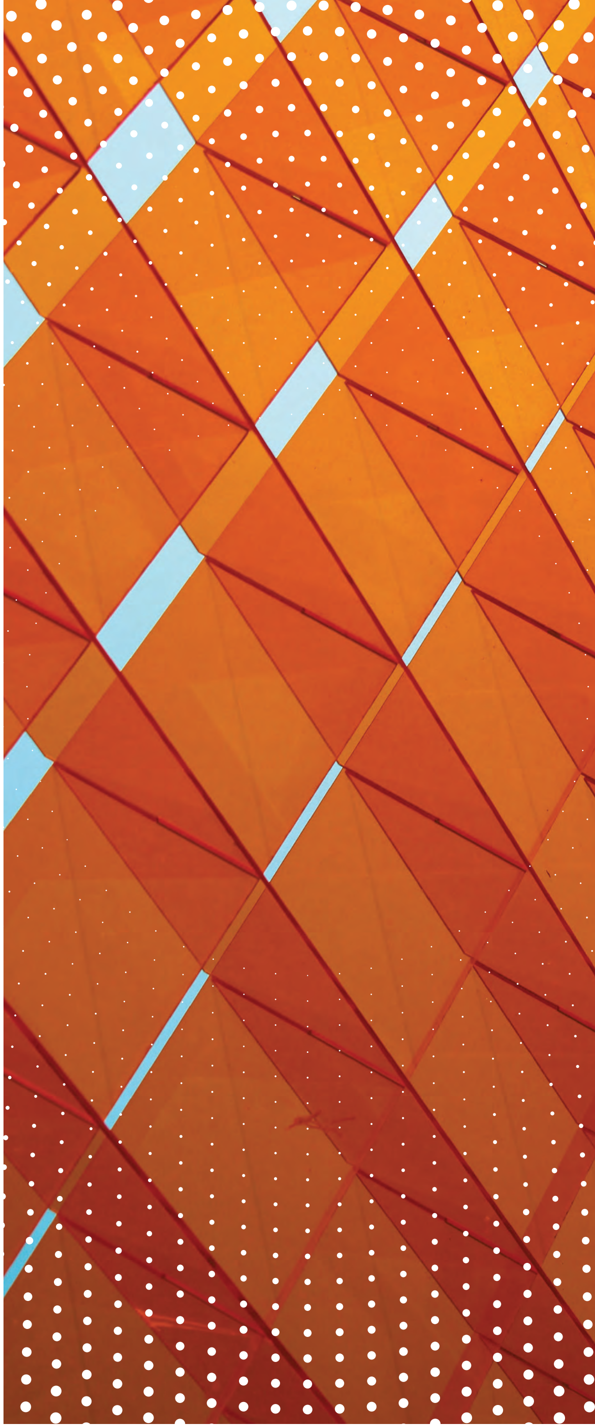
— Richard Cutcher, Captive Ambassador, Airmic

CONCLUSION: INSURING THE FUTURE

As captives become a more mainstream risk management and risk financing tool, captive owners are taking more control by opening them up to more complex risk exposures. In light of this, risk-intelligent captives are evolving — emphasising the need to leverage data, services, and insights from third parties. Collaboration with stakeholders will become more important, and the internal risk advisory board (where it exists) can assist with this cooperation.

This whitepaper and the events it themes are based on cyber, political risk, and storm surges as examples of complex risks. Still, there are many other opportunities for self-insurance through captives. Some of the more creative uses of captive insurers include opening them up to pandemic risk, ESG, supply chain, and employee benefits.

Where captive insurance is concerned, it is no longer an either-or conversation. Self-insurance has become a sophisticated tool in the risk transfer toolkit, with captives as a central underwriting hub and a critical part of the insurance value chain.



artexinfo@artexrisk.com
PHONE: +1 630 694 5050
PHONE: +44 1481 737 100
artexrisk.com

ATXUK100215