Mike Matthews and Paul Eaton

A NEW ERA FOR CAPTIVES

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As the firming of the (re)insurance market cycle continues, interest in captives has steadily grown. While capacity is starting to come back into the commercial insurance market, many companies are maintaining their commitment to self-insurance. Here's why.

Driven by tougher renewals, rate increases, and capacity withdrawals, insurance buyers have reframed their thinking about the opportunities that captives present as a strategic tool in their risk financing war chest.

Alongside the captive, as the core risk management tool, interest in complementary forms of alternative risk transfer, including parametric and structured product solutions, also show no sign of diminishing as part of an emerging trend in buying strategies which is looking further than the traditional market.

RIDING OUT A MORE CHALLENGING MARKET

It is no secret that captives have greater status in more challenging commercial insurance markets, but memories are short and the market dislocation that began in 2019 was a significant correction following a prolonged soft market. This first truly hard market in two decades, delivered double-digit rate increases across most classes and regions along with tightening terms and conditions.

Against this backdrop, those with a captive insurer have gained from much-needed pricing stability, predictability over coverage, and the benefit of increased control over claims. In addition, and perhaps of most importance, has been the ability a captive offers to align policies with an organisation's risk profile and commercial objectives. These attributes and benefits have always been available, but they have come back into sharp focus during the past three years.

For many market practitioners, it is the first time they have experienced such challenging renewal conditions in their career. "That's where some of the more seasoned risk professionals have a head start, having lived through a harder market cycle before," says Mike Matthews, commercial director at Artex International. "It's a real advantage knowing how you can quickly adapt and use a captive, particularly in a hard market where they offer a natural solution to cost control and coverage issues that arise."

"Between 2019 and through 2022, we experienced a substantial hardening of the market and accompanying that, a growth in captive opportunities," he continues. "Over the past 12 months, we've seen that plateau and some of the heat dissipate from the market. But there are still lines of business and industry sectors that remain distressed, and this situation looks set to continue."

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Within the property catastrophe market, for instance, reinsurers have been withdrawing capacity and increasing their attachment points. This forces cedents to retain more risk, and in turn, they then require clients to take greater retentions.

Insuring natcat exposure via a captive makes a lot more sense than keeping the risk on the corporate balance sheet, particularly as retentions increase, explains Matthews.

“If we take our experiences in Australia as one example, particularly with the windstorm in the Northern Territories, we have clients that are having to take significant self-insured retentions on their balance sheet because their primary carriers are being required by their reinsurers to take higher retentions,” explains Matthews. “It’s a significant knock-on effect.”

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INCUBATING EMERGING RISKS

According to Airmic (the Association of Insurance and Risk Managers in Industry and Commerce), captives have helped change the conversation for insurance buyers at a time when other options were short in supply. Back in 2021, the risk association described the ‘harsh market’ their members were struggling to navigate, with lockdown conditions exacerbating their ability to remain on the front foot during renewal discussions.

The use of captives grew as insurance buyers actively sought out alternative risk transfer solutions. In its research, Airmic found that existing captive owners (around 69% of its corporate members) were making more use of their risk retention vehicles. Meanwhile, a growing number of corporates without a captive were actively considering the establishment of one.

Cyber risk remains the most common ‘new’ risk to be insured within a captive structure, with German mutual MIRIS taking the concept to a new level when it was set up in 2022 by a group of European multinationals.

For those considering insuring some of their cyber risk via a captive there are crucial insights to be gained. It offers the ability to 'incubate' emerging exposures, allowing the company to better understand its risk profile and build up a claims history before it goes out to the commercial market. Most of all, it allows the client to use its captive to create a tailored policy that fits the company's needs.

"Cyber is a good example where captives are being used to underwrite specific programs which are designed around the individual organisation's risks," says Matthews. "One area we've been involved with helping our clients is providing access into Gallagher's cyber risk management expertise so we can determine the real exposures. This helps us to build out a cyber policy specific to the client."

A LONG-TERM PLAY

With capacity steadily returning into the commercial insurance market, the pressures that existed a year ago have somewhat eased. For instance, according to Gallagher's June 2023 US Market Report, prices are not hardening quite as rapidly within casualty classes, including cyber and D&O.

Nevertheless, pockets of distressed business remain across nearly all markets, and harder market restrictions and exclusions have yet to ease.

As most captive owners will attest, financing risk through a risk retention vehicle is a long-term strategy and not just a hard market solution. Regardless of the market cycle, captives can help insurance buyers gain more control over claims and a closer dialogue with reinsurance markets.

"If insurance buyers can deploy capacity using their captive in the mezzanine segment of the risk tower this will help attract reinsurers that otherwise would not be available to you," explains Paul Eaton, CEO of Artex International. "That's where captives really come into their own."

Captives create the opportunity to take a more holistic approach to a wide scope of organisational risk, including those risks not typically covered by traditional insurance. This includes employee benefits. This area has expanded significantly since the global pandemic, with more focus on issues, such as employee wellbeing and mental health, in addition to more standard life and health offerings.

As employers battle the 'Great Resignation' and invest more to retain their talent, captives are being utilised as a vehicle through which to fund a more sophisticated range of benefits.

"We experiencing a meeting of minds between the HR and risk manager giving rise to a more holistic risk conversation," explains Matthews. "This extends beyond standard life, disability, and pension-type programs to encompass wellbeing plans that attract and retain good staff.

"Traditional insurers generally don't offer a solution, whereas a captive can help fund these programs."

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COMING OF AGE

Building up a diversified captive portfolio, including property and casualty risks, brings other long-term benefits. It helps optimise capital requirements and assists the parent company to build a more balanced book of insurance exposures over time, offering stability and greater profitability.

In authorising any new risk retention vehicle, regulators require approval of the business model and will need to be satisfied that adequate due diligence has been undertaken and a robust strategy is in place. Captives must be adequately funded for the solvency, risk, and aggregate limits being assumed.

However, given the stretched resources of some supervisors, the captive formation process is currently taking longer in some jurisdictions. This is where the advice and experience of a seasoned captive manager is essential, leveraging the full advantage of their knowledge of different regimes, and strong relationships with supervisors and fronting carriers.

Depending on the company's size and risk appetite, access to different captive structures, such as cell companies with fast-track approval permissions, can help lower barriers to entry. There has never been more choice, with a growing number of jurisdictions offering captive legislation, both onshore and offshore. But for captive insurance to truly come of age, more support and education is still needed, thinks Eaton.

"We need more alignment on the underwriting of risk programmes which use captives," he says. "The biggest single issue generally is gaining access to fronting closely followed by reinsurance capacity.

"With the exception of one or two carriers, who have got their heads around the captive concept, the support we need is not yet there, despite the growth opportunities. If we really want to see some movement in this market, I'd like to see more fronting carriers working with existing captives," Eaton concludes.

Mike Matthews

Commercial Director, Artex International

As the commercial director for Artex International, Mike is responsible for the commercial strategy, including sales, marketing, product development, and client services support to drive business growth and market share. Mike has over 30 years of senior management experience in both the international non-life and life insurance sectors. He has a proven track record of creating, and early-stage management of, pioneering (re)insurance start-up and growth organisations. Mike has been a member of, and strategic advisor to, multiple boards, executive and sub-committees of both non-life and life insurance organisations across the globe. He has a reputation for successfully managing complex insurance projects, designing and delivering innovative solutions, identifying market opportunities, and in shaping a business plan to exploit such opportunities.

Paul Eaton

CEO, Artex International

Paul Eaton is an experienced (re)insurance professional with a strong background in underwriting, business development, risk financing, and (re)insurance company management. Paul is currently the CEO of Artex International, and is based in Guernsey. In this role, he serves on the Artex executive leadership team, driving strategy around talent, organic growth, mergers and acquisitions, and operational efficiency for Artex's operations in Guernsey, Gibraltar, Malta, London, Ireland, and Singapore. His responsibilities also include serving as a director for a variety of Artex clients and boards.

With 32 years of industry experience, Paul began his career at Royal & Sun Alliance, where he held various underwriting and management positions over a 13-year period. He joined Artex Risk Solutions in 2004, where he has held a number of roles, including client account management, head of business development, and commercial director for Horseshoe following its acquisition by Artex in 2019.

Paul holds a bachelor's degree in engineering from the University of Warwick and is an associate/chartered insurer of the Chartered Insurance Institute.

THE ART OF RISK

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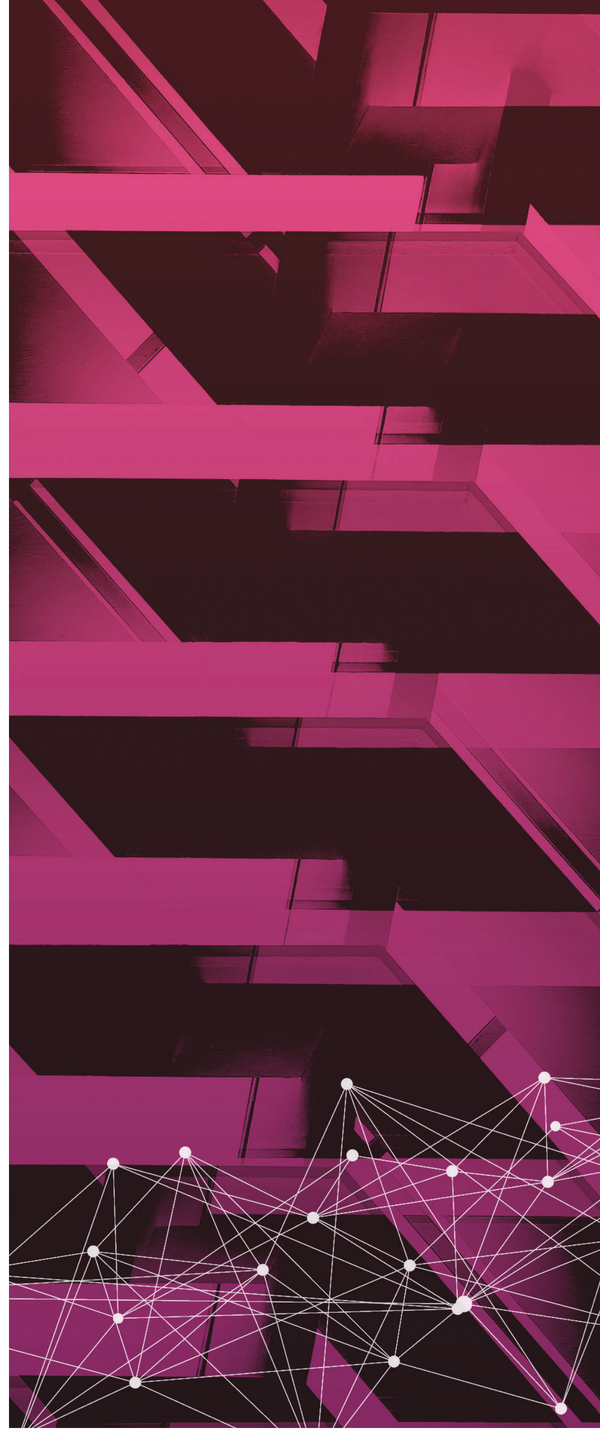
Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital. At Artex, we believe in finding you a better way.



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