Artex | Alternative Risk

Navigating the Captive Industry Through the Lens of a Broker

How do I know if a captive solution is right for my client?

It is no surprise to most insurance professionals that the current insurance marketplace has become increasingly distressed in recent years. The third quarter of 2022 marked the twentieth consecutive quarter of commercial property and casualty premium increases, with average increases across all account sizes of 8.1%. Furthermore, double-digit increases continued on particularly distressed lines such as commercial property at 11.2% and cyber at 20.3%.[1] The ongoing fallout related to the Covid-19 pandemic, climate change, the increase in nuclear verdicts and litigation costs, and inflation have all played a role in driving rate increases. The global risk environment is arguably more complex, uncertain and volatile than it has been in recent decades.

Q3 2022 = 20
consecutive quarters of
P&C PREMIUM INCREASES

As market headwinds have continued, the pace of new captive formations continues to surge as clients look for alternatives. All major US domiciles, as well as Bermuda and Cayman, saw strong numbers of new captive formations in 2021 and 2022. Vermont, as an example, noted 2021 as its fourth highest year on record for new formations, trailing only its first year as a captive domicile and the two years following 9/11.[2] Captives have been increasingly attractive to companies and organizations as they face decisions around how to retain vs. transfer more risk, access additional capacity and achieve greater stability over the long term. As insurance brokers navigate these decisions with clients, they must understand when and how to deploy a captive strategy as an effective alternative, and also how to appropriately set expectations with clients.

As the old proverb goes: "The best time to plant a tree was 100 years ago. However, the second-best time to plant a tree is today." The same concept holds true for a captive insurance strategy. While we cannot change the current conditions of the market, we can advise brokers on best practices and alternative solutions so they can be better-positioned future forward.

Before we discuss the role that captives can play in navigating a hard market, it is first important to address the concept of risk management, as this will play a crucial role in the success of a captive insurance program.

[1] https://www.ciab.com/resources/q3-2022-p-c-market-survey/

[2] https://riskandinsurance.com/2021-was-a-busy-year-for-vermonts-captive-industry-what-will-2022-bring/#:~:text=%E2%80%9C2021%20was%20the%204th,licenses%20on%20January%201%2C%202022

Navigating the Captive Industry Through the Lens of a Broker

How do I know if a captive solution is right for my client?

THE MANAGEMENT OF RISK

The most effective way for an organization to gain greater control across their insurance program is through the assumption of risk. Once an employer is comfortable assuming risk, the conversation needs to shift to: "how are we going to manage the risk the client now assumes?" Many of our successful captive clients work in conjunction with their insurance brokers to build a robust risk management program that incorporates best practices, various loss control initiatives and a proactive plan to manage claims when they do occur.

Whether that control comes in the form of utilizing a TPA for claims handling or having a choice of counsel, insurance companies will only relinquish those elements of control when the insured commits to assuming a portion of the risk. With a comprehensive risk management plan identified, brokers and their employers can then begin to evaluate different risk financing mechanisms such as captive insurance solutions.

As an insurance broker, it is important to identify the do's and don'ts of implementing or recommending a captive strategy for your client. What better way to address these than addressing some of the myths within the market? Below are a few of our favorites.

- A captive will save me money immediately
  - » Instead of immediate cost savings, the captive focuses on financing risk more efficiently over the long term. In most cases, the captive may be comparable or even more expensive to the traditional marketplace. However, captive strategies are designed to provide employers with long-term stability, which spans three, five and 10+ years across hard and soft market cycles.
  - » Captive solutions are most effective when they become the centralized hub for the overall risk management plan. Thus, providing employers the flexibility to be nimble with the captive's assumed portion of risk as market conditions change.
- A captive will replace my entire insurance program
  - » An employer will rarely be 100% self-insured across their overall insurance program. In most cases, employers will still transfer a portion of risk to the marketplace for claims that are too hard to predict or catastrophic in nature. This element of risk transfer can take the form of a stop-loss policy, excess policy or various reinsurance transactions.
  - » As a result, a captive will not replace the entire insurance program. Instead, the captive will look to take on a layer of risk that is predictable for the employer to assume.
- A captive can be a quick fix
  - » Ample time is one thing that is absolutely needed in order for a captive evaluation and overall integration to be successful. Captive insurance solutions take time across different platforms. For context:
    - Employers: need time to understand the fundamentals of captive insurance strategies, how they can be utilized, and what strategy and risk level are appropriate for them.
    - Actuaries and underwriters: need time to review the risk profile and model out the projected loss scenarios for the captive's assumed risk.
    - Captive regulators: need ample time to review the application, understand the proposed business plan and ultimately the issuance of the captive license.
    - Brokers: need time to build out the remainder of the insurance placement outside of the captive's assumed risk and negotiate with other markets.
  - » At minimum, captive solutions can take anywhere from 3-6 months to implement successfully into an overall insurance program.
  - » In our opinion, the best time to evaluate a captive insurance solution is immediately following a renewal to prepare for the following year or at least six months in advance of the renewal.

Navigating the Captive Industry Through the Lens of a Broker

How do I know if a captive solution is right for my client?

By debunking these myths, brokers are able to not only better understand how to deploy a successful captive solution despite the market continues, but also clearly communicate with employers to effectively evaluate a captive insurance solution. Recently, the emerging trends for captive insurance solutions have been in the following areas:

- Increased retentions on primary lines of coverage
- Participating in a quota-share arrangement in higher layers of the tower
- Filling in insurability gaps in capacity or coverage
- Increased cell formations as an expedited fashion to enter the alternative risk market
- Cyber liability
- Directors & Officers
- Medical stop loss
- Third-party insurance programs

These emerging trends have become most prominent across several industries. Most notably, transportation, construction, healthcare and large real estate companies continue to see a benefit from integrating alternative risk solutions like the establishment of a captive insurance company. As we continue to face headwinds within the marketplace, we have also seen an increase in higher education and financial institutions evaluate captive insurance strategies as a way to mitigate the pressures from the marketplace.

While these are exciting trends within the captive industry highlighting flexibility in a dynamic market, they also serve as a reminder to the importance of appropriately setting expectations with insureds. It is imperative that brokers properly identify the goals and objectives of their clients at the outset of the captive evaluation process. The employer needs to understand both what is realistic in terms of captive potential in the immediate future and develop a well-thought-out strategy for the captive to evolve over time. There are a number of key considerations for brokers, and their clients, to contemplate early in the captive process.

UNDERSTAND MARKET IMPLICATIONS

- Determine which lines of coverage to include in the captive and what the impact may be on other lines of coverage placed in the traditional market (either with one or multiple carriers).

UNDERSTAND THE DIFFERENCE BETWEEN GROUP CAPTIVES AND SINGLE-PARENT CAPTIVES (SPCS)

- SPCs can provide clients with more flexibility in terms of structure and coverage offerings, but many middle-market organizations may not have the scale to effectively utilize an SPC. Additionally, SPCs often require more capital investment on the front end and more lead time for the captive formation.

IMPACT OF ADVERSE LOSS RESULTS ON THE CAPTIVE

- The 1-in-100-year event is as likely to happen in year one as it is in year 100. It is important to address whether the client has the financial capacity to absorb potential adverse loss results early in the captive life cycle.

Navigating the Captive Industry Through the Lens of a Broker

How do I know if a captive solution is right for my client?

FINANCIAL AND TIME COMMITMENT

- Impact of capital requirements dependent upon the scope of the captive
- Rarely do captives require an organization to hire additional staff, but they will require oversight from the risk management and finance teams.

EVOLUTION OF THE CAPTIVE

- As the captive matures and builds surplus, the captive can evolve to provide additional value beyond the original scope. Successful captives have a long-term strategic plan that is designed to flex as the client's goals and objectives change over time.

Many clients may not be able to address all of these considerations at the onset of their captive formation, which is quite normal. However, the brokers who effectively position captives as a viable alternative for their clients are those who involve a trusted captive manager early in the process. An effective captive manager will by no means look to replace or supersede the role of a broker, but rather act as a partner in helping the client to address the key considerations and navigate the alternative risk marketplace. At Artex, we are here to support our insurance broker partners as they navigate the captive industry on behalf of their clients despite market conditions.

AUTHORS

Chelsea Carter
Account Executive — Business Development
North America
Chelsea_Carter@artexrisk.com

Ryan Santacrose
Head of Sales
North America
Ryan_Santacrose@artexrisk.com

THE ART OF RISK

At Artex, we believe there is more to alternative risk management. As a trusted leader and provider of diverse (re)insurance and ILS solutions, our global team operates at the intersection of art and science—where creative thinking meets expertise and superior outcomes are made. That's how we're able to fully understand our clients' needs and deliver the most comprehensive solutions available.

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.

Artex

artexinfo@artexrisk.com
+1 630.694.5050
artexrisk.com