Conservative innovation

While captives remain at their heart conservative risk vehicles, their deployment and application has grown increasingly innovative and sophisticated over time.

As Sandra Duncan, vice president of operations at Captive Resources explained, "The types and uses of captives are now much more diverse and their growth and development has logically trended with new and emerging risks and the increasing sophistication and influence of the risk management function in general."

Captives are also being considered more readily by CFOs and risk managers looking to add emerging risks to their programmes, said Duncan. "Captives have developed from a somewhat reactionary, hard market alternative, to a proactive and strategic risk management tool that has moved beyond the cost reduction mind-set, to recognise multiple benefits."

This has led to captives being deployed in new lines of business, in new forms, in new geographies and being applied to new uses. As Les Boughner, executive vice president and managing director at Willis Global Captive and Consulting Practice explained, captives and their parents are often the drivers of this innovation, recognising a need and putting their captive to work fulfilling that requirement. "We often field questions from clients asking 'is there any reason we can't use the captive for this?'—I am constantly impressed by the ingenuity of our clients."

One area of innovation is the type of risk being underwritten through the captive. For David Gibbons, director of the captive insurance group at PwC Bermuda, one of the major areas of growth is the increasing use of captives by large multinationals to fund employee benefits. "This is a major trend and many captives are over time moving those programmes into their captive in order to centralise the process for managing those risks."

Richard Irvine, managing director and tax leader at PwC, said that US benefits would likely remain onshore with US branch captives, but that "global employee benefits programmes—with the exception of the US piece—are increasingly making their way into offshore captives". Gibbons said that Bermuda's reinsurance market represents an attractive proposition for those writing such business in instances where there are requirements for fronting arrangements. The strength and capabilities of the Island's reinsurance carriers can deliver just such fronting arrangements for captives in new and emerging domiciles.

Addressing the innovative utilisation of captives, Boughner highlighted the case of a Bitcoin company, which is using a captive structure to provide an insurance solution that is not being addressed by the conventional insurance market. He said that its captive enables the

company to access the reinsurance market and materially increase its capacity. "While the structure is not innovative, its application is something new and interesting."

Boughner cited a second example: that of a risk retention group for orthopaedic surgeons that is also finding innovative uses for its captive. He said that the group had moved from "individual practices purchasing their own insurance coverage, through to the development of a risk retention group for medical malpractice and looking at a group captive for workers' comp and possible medical stop loss coverage". They had even formed their own insurance agency to provide non-pooled coverage to individual physician groups. He added that he had seen similar things done with state-wide university systems, where a captive enables the entity to exert "total control" over its insurance programme.

Irvine said that captives are handling and developing coverage for a range of esoteric risks, such as launch coverage for satellites and later for loss of use. "The capabilities of captives are really about the creativity of the risk manager and the wider market. The opportunities for their application are limitless; the only limit is the market's willingness to accept new risks."

Boughner added that there is continued interest in putting captives to work insuring emerging risks such as cyber and reputational risk, although he admitted that as yet interest has been more marked than actual application. Irvine echoed his sentiments, but he did indicate that captives are already taking on cyber and reputational risks, if only in small numbers for now.

"The challenge will be getting a grip on exposures," said Irvine, with even the commercial market proving wary of potentially significant and unrecognised liabilities in the space.

One line that has considerable untapped potential is credit and political risk, said Bob Svensk, CEO of Latin American Underwriters. "Writing credit and political risk through your captive is grossly under-utilised at present, because such risks tend to be the domain of the international credit manager, rather than the risk managers who traditionally manage captives."

He argued that credit and political risk has the potential to inject innovation and diversification into a captive, "delivering the same benefits for your credit and political risk business as you would enjoy from all your other lines of insurance".

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"A captive can help a parent to absorb its deductibles and co-insurance costs and provides them with access to the reinsurance market. It can also pick up exposures that the conventional markets don't even want to think about, or be there to supplement another underwriter's capacity limits. The same arguments you would use for a P&C captive apply to risks such as credit and political risk environment as well." Svensk said that captive parents need to consider the optionality that a captive entity brings to their risk management appetite.

Captives have also innovated in their form said Svensk, with "perhaps the biggest innovation over the long haul being the rent-a-captive concept". He said that such entities deliver definite advantages from a cost perspective for those parents looking for more pared-down entities.

Irvine said that he sees considerable opportunities for middle market growth and innovation among those captives that satisfy the demands of that section of the market. "The total risks and size of the companies employing captives is getting smaller. This is an opportunity for Bermuda and the wider captive market as middle market companies increase their risk sophistication." Middle market development is the next obvious step in captive evolution, said Irvine, as the frictional costs of running a captive fall and as markets grow increasingly global.

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Boughner added that captives are also getting in on the burgeoning insurance-linked securities (ILS) sector, particularly in Bermuda. “ILS are helping to rejuvenate the Bermuda market. Fundamentally, ILS are a form of captive insurance.” He added that for unique hard-to-place risks, a catastrophe bond could form the perfect complement to an existing captive structure, with a number of large energy companies considering just such a proposition. Irvine added that Bermuda’s recent special purpose insurer (SPI) legislation had prompted a boom in new reinsurance formations that can only serve to complement the Island’s existing reinsurance capacity.

Addressing perhaps the most recent innovation in the captive space—the introduction of a dormant status for captives by Vermont—Boughner said that such measures will help to sustain captives by reducing the capital requirements for non-operating entities. He said that this will help to sustain the “dynamic strategy” that should form part of a parent’s cyclical management, and added that the change had made it more “financially attractive to maintain a captive than to shut it down”, and it is likely that other domiciles will follow Vermont’s lead.

Addressing the value that captive innovation can bring to the parent, Duncan said such an assessment needs to be considered “within the context of each individual captive owner’s goals and objectives”. She said that innovation within the captive sector has generally led to greater accessibility to captive insurance to a broader array of companies. While group captives are by no means new, significant growth in recent years has resulted in companies of varying sizes becoming captive member-owners. In the group captives it advises, Captive Resources sees companies with combined casualty premium ranging from $250,000 up to $10+ million, said Duncan. That’s a big change from the $100,000 to $1 million range that was more typical, say, 10 years ago.

“Thanks to innovation in form and function, these principles can now be applied to a broader array of risks,” said Duncan. Svensk added that captives enable their parents to “plug into the insurance system”, becoming a member of the market, rather than simply a buyer. This helps them to glean information on rates, trends and developments that can help to drive further innovation in their use of captive insurance.

Duncan concluded: “Innovation has helped to spur increased competition among service providers and domiciles, which in turn has driven down startup and operating costs. In general, a greater variety of captive applications, entrenches captive insurance as a more mainstream, versatile risk management tool.” ●