TRUSTED INSTINCTS

Caroline Cruickshank and Robert Thorson of BNY Mellon investigate the shifting captive landscape

In the natural world, adaptation is part of the evolutionary process and where the fittest, or the most adaptive, stand to survive. So too, in the business world, adaptive strategies are needed to ensure continued business growth and to maximise impact in an evolving market. Corporations have many tools at their disposal to help them navigate these waters, such as captive insurance.

Captives, as a form of self-insurance, are established to meet the risk management needs of their corporate sponsors or members. They can cover a wide range of risks, while providing cost-efficiencies and flexibility for their sponsor. Captives are also keenly adaptive to the market environment they operate in.

Take collateral requirements. Captives are often required to post a financial guarantee to their fronting carrier to demonstrate they will be able to pay potential and future insurance obligations. The most common type of collateral provided is the bank-issued letter of credit (Loc). However, with the growing cost of credit and scrutiny over the true security of Loc-issuing banks, it is no wonder that collateral alternatives such as insurance trusts, which are much more flexible and cost-effective, have become increasingly popular.

While insurance trusts have helped captives to stay ahead of the evolving financial landscape, captives' adaptive abilities don't stop there. They are responding to changes in regulatory, competitive and business demands by charting new strategies which have created some interesting trends across the wider industry. Some examples follow:

Adapting onshore: the shift from offshore

Captive insurance has grown significantly over the years. While captive formation has traditionally been popular in offshore jurisdictions, like Bermuda, the reach of captives has gone global. Today, the captive industry spans across 67 domiciles worldwide, with approximately 6,900 captives *(source: Business Insurance)*.

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For captive owners in the United States, this popularity has opened new doors with access to new domicile choices, including onshore. Since the introduction of the Dodd Frank Act in 2010, many US states have created or enhanced existing captive legislation in their jurisdictions, motivated by the potential economic benefits that a home-based captive insurance industry can bring, such as additional tax revenue and growth in jobs.

There are approximately 40 states that now permit the incorporation of captives, a very different reality to a decade ago where only a handful of onshore US states offered this. For tax and other considerations, some sponsors are redomesticating their captives from offshore domiciles to be more local, or forming additional captive insurance programmes in their home states to supplement offshore programmes.

Take Tennessee. Since launching captive legislation in 2011, it has licensed 126 captives, 57 of these were new in 2015 alone, including seven redomestications from other domiciles *(source: Tennessee Department of Commerce and Insurance)*. And Tennessee is not alone. Evidence of redomestications from out-of-state locations can be seen all over the US, from Vermont to Montana.

Along with adapting to new domiciles, captives are also being used to cover new risks.

Adapting coverages: expanding the use of captives

Types of risk covered by captives can vary but have traditionally included property, casualty and workers compensation. Generally, among larger corporations, there is growing focus in placing supply chain and reputation risk into captives. Among captives for medium-sized enterprises, there is a resurgence of professional liability and errors and omissions coverage.

With an evolving enterprise risk management landscape, many corporate sponsors are expanding the use of their captives into emerging or non-traditional risks, such as crime, commodity, trade and political risk. For instance, the threat of cyber terrorism to infrastructure and other critical assets could drive sponsors to use their captives where coverage limits from traditional insurance may not be sufficient, while growing healthcare risk coverage is being driven by Obamacare reforms. There is also potential for further growth in employee benefits coverage, and for post-retirement medical risks going into captives.

According to Marsh's *2016 Captive Benchmarking Report: Creating Security in an Uncertain World*, "the fastest-growing non-traditional risk for 2015 was multinational employee benefits, which grew 143% over the previous year" and "the number of captives using cyber-liability programmes has increased by 30% from 2014 to 2015".

As we look to the next few years, captives may be able to assume more and more risks on their own. A greater share of risk retention could help to improve their sponsors' access to the reinsurance markets, thereby offering even greater flexibility to meet evolving risk management needs. We are already seeing how alternative structures, such as special purpose insurers, can add value for their sponsors in new ways.

Adapting structures: innovating to add value

Traditional captive structures include pure captives that insure the risks of a parent company who maintains control over the underwriting terms and reinsurance and investment decisions; rental captives formed by investors and used by organisations that cannot form their own; association captives who underwrite the risks of members of an industry or trade association, plus many other types.

The rise of one particular class structure, special purpose insurers (SPIs), is drawing increased attention. SPIs are typically formed to undertake insurance securitisation or transformer type business, known as insurance-linked securities (ILS), where the insurance obligations are fully-collateralised. With the growth of ILS, innovative risk transfer financing is helping insurance and reinsurance sponsors to raise more alternative capital.

In the last year, there has been interest in ILS products by non-insurance entities such as the issuance of catastrophe bonds by corporations. Corporates are engaging with specialist advisors to explore effective ways to secure insurance coverage from the capital markets. Catastrophe bonds have the potential to provide cost-effective risk protection for prescribed natural catastrophe perils, such as damage from storm surges, and are fully-collateralised with proceeds invested into a collateral trust. While catastrophe bond payouts are linked to various parameters, they may have the potential to offer more rapid loss recovery. This could benefit corporates who are looking to reduce the risk of lengthy business interruption after an event.

As a source of ILS risk transfer financing, SPIs have tremendous potential to create value for their corporate sponsors over the next few years.

> "With an evolving enterprise risk management landscape, many corporate sponsors are expanding the use of their captives"

The importance of a right service provider

Whether redomesticating, supplementing an insurance programme, expanding risk coverage or undertaking fully-collateralised reinsurance arrangements, captives seem almost instinctively able to adapt their strategies to meet business objectives. In an environment where the sponsor's cost management objective is increasingly key, many captives continue to turn to insurance trusts as a low-cost alternative to meet collateral requirements for insurance obligations.

Insurance trusts are easy to set up, significantly less expensive than Locs and do not encumber the captive's or sponsor's credit. Trust accounts can be evergreen and are typically funded with financial assets that are pledged to a designated insurance carrier as sole beneficiary. The collateral posted is an amount sufficient to ensure that the captive will fulfil its obligations and can be adjusted as the captive writes more or less business. There is even potential for income generated on the portfolio of assets to be directed back to the captive.

It is important, therefore, to choose the right insurance trust provider. A trustee who has a long-standing reputation in the market, strong relationships with carriers and advisors, and who can expedite the account set-up process, is crucial. The trustee should also be able to demonstrate deep expertise and knowledge of insurance collateral requirements under any of the US regulations such as 114, 20, and NAIC Surplus Lines to name but a few. Furthermore, as collateral becomes an increasingly important aspect for captives doing business in many jurisdictions worldwide, a trustee who can offer global resources to seamlessly support cross-border collateral requirements and unlock asset values through sophisticated collateral optimisation techniques, will add the most value.

Finally, a trustee who is recognised for service excellence will help sponsors and their captives to achieve their financial objectives, whether in the traditional or alterative risk transfer markets.

In conclusion, captives have demonstrated a unique resiliency as they adapt to the evolving market environment in which they operate. Working with their sponsors, advisors and service providers, captives are able to leverage the tools they need to stay ahead of the curve to ensure continued business growth and to maximise their impact, today and for tomorrow. Trust in that.