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Captives: after the hit

Caroline Cruickshank, of **BNY Mellon**, discusses how captives have developed increased risk awareness since the 2008 financial crisis

CAROLINE CRUICKSHANK, strategy manager for the BNY Mellon Corporate Trust group based in Toronto, drives strategic initiatives around the corporate and insurance client segments. Prior to this role, Caroline was a sales representative for Corporate Trust's Canadian and European businesses. She was instrumental in establishing the sales coverage for the Insurance Trust product in Europe.

A few years ago, a renowned heavyweight boxer was being interviewed before a highly publicised championship fight. The interviewer had described how his opponent had developed a game plan to win the champion title. Responding to the interviewer, the boxer was accredited to have said: "Everyone has a plan… until they get hit."

It's not often that we look to the boxing ring for wisdom. Yet, this observation rings true in many ways, especially if we consider the impact and legacy of the financial crisis and the resulting trends shaping our present and future financial climate.

Financial climate and risk awareness

In 2008, the Lehman Brothers' bankruptcy, the government bail-out of the banking system, housing market collapse, and global credit contraction severely depressed the markets. Almost five years later, financial indicators still show signs of depressed conditions, like the continued low interest rate environment, looming fiscal cliff, ratings downgrades, a higher level of regulatory scrutiny and geo-political uncertainty in regions like the eurozone and beyond.

Like all good boxers, getting back up after a hit is key. Emerging from this depressed financial environment, seems to be a stronger awareness of risks, and a requirement for enhanced risk management practices, improved risk mitigation tools – including increased collateralisation and capitalisation, and for more transparency to manage complex risks. This has led to distinct trends shaping the present landscape for many industries, including captive insurers, their corporate parents and the insurance industry as a whole.

Among these trends, we're seeing a heightened awareness of counterparty risk and the rising importance of collateral as a form of security. For instance, Fronting Carriers are driving collateral requirements for captives as a means to reduce their risk exposures and preserve credit ratings. However, as bank liquidity is being squeezed as a result of greater restrictions on lending, the cost of credit is rising. Since collateralisation is becoming more commonplace, captives who have to collateralise their insurance obligations with Fronting Carriers are demanding more cost-effective alternatives to credit.

Another trend involves increased transparency needs, not just driven by regulatory oversight but by investor or shareholder demand for enhanced analytics to enable quicker decision-making. As a result, insurers are being forced to measure risk in new ways which can impact insurers' capital and risk management behaviours. If they fail to balance it right, the higher cost of capital may derail their competitive strength. Enhancing transparency will require more detailed asset performance reporting and analytic tools to effectively measure and monitor investments and collateral requirements.

We are also seeing a general trend around cost containment. For instance, parent companies are re-examining captive balance sheets for any idle cash that can be diverted to other corporate uses; captives will have to work harder to justify their capital resources. Choosing a less expensive and more flexible alternative form of collateral may help captives manage their capital resources more efficiently to meet their parents' expectations.

Finally, the relative GDP growth in the emerging markets is fuelling companies' desire to chase opportunities in these new territories. Corporates are extending their operations and production, and insurance companies are being established in new insurance markets. Combined with a rise of global captive domiciles, we see this leading to an increase in global cross-border fronting insurance and reinsurance needs, sparking a requirement for more sophisticated cross-border collateral solutions.

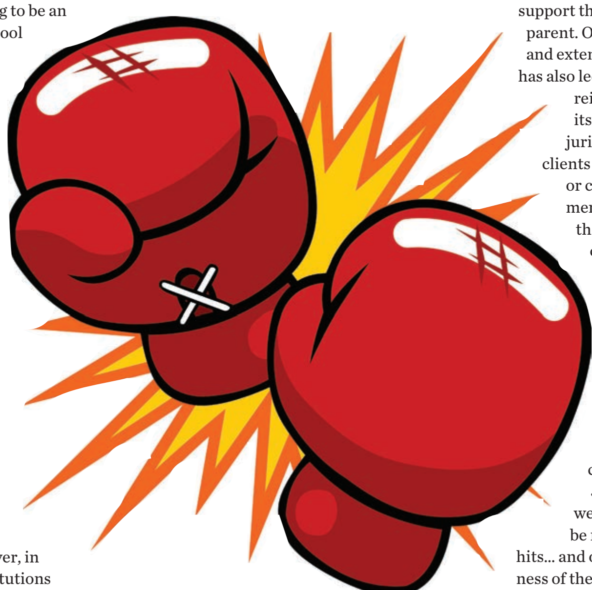
Changing risk coverage

A stronger awareness of risks and increased transparency to manage complex risks will continue to shape captives' present and future landscape. The potential to extend the types of risk coverage placed into captives and to modify existing levels of risk retentions are strategies that may help to further contain cost and rising premiums, while maximising tax benefits in this environment.

According to the *Captive Insurance Companies Association (CICA) 2013 Market Study*, captives face certain challenges in the current financial climate. Risk retention, capacity to grow and expanded utilisation are areas that top this year's Market Study survey. We are seeing a rise of new risks coverage being placed in captives which may be driven by a lack of coverage availability in the commercial insurance market and ultimately by a need to reduce overall reinsurance costs. Survey respondents cited an interest in placing new risk types, like employee benefits, medical stop loss, disability benefits, and accident and health coverage into their captives.

Additionally, changing regulatory drivers are also sparking new behaviours. A growing number of micro-captives, or 831(b) captives, are being established by middle-market companies with self-funded health care programmes looking to pool some of their excess medical claims costs into a captive structure to mitigate rising premium costs under changes to the Patient Protection and Affordable Care Act.

Underpinning these new risk coverages, we see collateral continuing to be an important risk mitigation tool for the captive and within reinsurance/fronting insurer arrangements. The form of collateral supporting these arrangements will also be key as captives will look for flexible, low cost collateral solutions to help maximise overall value, and where the fronting carrier or reinsurer may look to reduce the credit and concentration risks associated with Letters of Credit.



Collateral choices

Traditionally, the letter of credit (LoC) has been the most common type of collateral sought especially when credit availability used to be plentiful. However, in today's climate, many institutions are re-evaluating their business strategies and re-balancing the cost of their credit exposures – a direct result of the ongoing erosion of their balance sheet capital and further pressures caused by the ratings downgrade trend and unease in market confidence.

Reinsurance trusts are an alternative form of collateral, significantly cheaper than LoCs. They are not credit instruments but accounts where a captive's obligations are secured by a deposit of eligible financial assets pledged to a designated insurance carrier as beneficiary. A trustee acts with contractual obligations over the account. In an event of default, assets can be called on to 'shore-up' the fronting or reinsurance agreement.

A reinsurance trust is easy to set up using standard documentation. Arrangements do not require yearly renewals, and the collateral amount can be adjusted as more or less business is undertaken. Liabilities can also be aggregated into a single trust per carrier to provide greater efficiencies. A reinsurance trust can compliment a cedant's risk management by reducing the credit and counterparty risks associated with LoCs. Finally, reporting and analytics can also help to streamline the back-office tracking functions and enhance data management and increase transparency.

BNY Mellon is a leading provider of reinsurance trustee services and we closely monitor market trends to ensure we remain at the forefront of industry changes to add value for our clients. We offer specialised reporting and analytics to meet increased transparency needs, and comprehensive access to a wide range of investment options to support the captive's value to its parent. Our global resources and extensive custody network has also led to the growth of the reinsurance trust (or its equivalent) into new jurisdictions to help our clients meet local regulatory or commercial requirements, while providing them with a reliable and comprehensive cross-border collateral solution. We have also supported captives who are expanding their risk coverage, as well as 831(b) captives, who are looking for cost-effective and flexible collateral solutions.

Just like the heavyweight boxer, we must be ready to anticipate the hits... and our increased awareness of the risks and risk mitigation tools, like collateral, will certainly help us to get back into the ring for another round.