

Come rain or shine

Why the value of captive participation remains constant whether in a soft or hard market.

By Steve Bauman and Lynn Cordes

WHILE CAPTIVE insurers continue to be referred to as alternative risk transfer vehicles, incorporating captives into risk management strategies is mainstream among companies looking to achieve greater stability in insurance costs, capacity and availability irrespective of what may be happening in the traditional market.

Whether a customer is large enough to form a single-parent captive or is sized more appropriately for participation in a group captive, the captive strategy has worked exceptionally well for a growing number of organisations during “normal” economic times.

However, what about economic times that are anything but normal? As the global economy continues to reverberate with the impacts of an unprecedented financial crisis, will most well-managed and adequately capitalised captives be in a position to continue to deliver the benefits of stability and flexibility that they have in the past?

In our opinion, the answer is clearly yes, despite the current financial climate. In fact, we believe that many owners and participants will realise the benefits of captives to an even greater extent in unsettled times than they anticipated when their captive relationships were established.

Inherent benefits

The fundamental value of a captive has always been the certainty that it will be there when the owners or group participants need it, whether the need is triggered by a precipitous rise in the cost of traditional insurance, the inability of the organisa-

tion to secure needed capacity or simply the desire to capture greater savings and efficiency.

Because captives are risk management tools, not investment vehicles, prudent captive managers will have implemented investment, capital preservation and risk assumption strategies aimed at achieving optimum levels of stability during normal cycles of market volatility.

Those qualities will come to the fore in the present financial landscape. Given the current volatility in the global financial environment and the potential for impacts on the insurance markets, well-managed and sufficiently capitalised captives should be poised to deliver promised stability at a most critical time.

In such an environment, a captive vehicle will increase a risk management programme’s ability to react to dramatic changes in the marketplace. This flexibility is especially valuable when events affect risk management programmes spanning more than one country. The continuing global financial realignment is likely to result in variations in conditions from one country or region to another.

These variations may result in localised market hardening or reductions in capacity, while leaving other areas largely unaffected. This could challenge multinational risk management programmes with coverage gaps, one of the problems that captives were originally created to address.

The short-term affects of the global financial crisis on insurance capacity and availability will likely reveal that risk management programmes of multinational

organisations with captive components to be in advantageous positions compared with those not partially insulated by captive vehicles.

Indeed, if the insurance markets ultimately harden more generally due, in part, to the world financial situation, it could be the most eloquent illustration to date of the stabilising value of captives.

All of which begs the question, what are the chances that the economic downturn will in fact help trigger a market hardening or a global contraction in capacity?

Turning point

At this writing, the situation is still too fluid for anyone to predict with certainty. However, some signs are beginning to appear. At least one major insurance industry financial strength ratings firm, Fitch, is predicting that balance sheet pressures on some insurers and reinsurers will become more severe as they experience significant unrealised market value losses and take impairments on their investment portfolios.

That agency expects an increase in the reporting of unrealised capital losses in third-quarter results. It is difficult to envision a scenario in which a reduction in capitalisation would not have an impact on capacity or pricing on many lines of insurance. Once again, customers with captive components built into their programmes will be well positioned to react to changes more quickly and with greater flexibility. In the end, time will tell what effect economic conditions have on the market.

Whatever happens near term in the global insurance market, you can be sure



that “normalcy” will ultimately return. The cyclical nature of the insurance business is probably not likely to go away soon. Thus, even if a market hardening does occur, as soon as surplus and profit outlooks improve, the traditional, downward pressure on rates will likely reassert themselves.

Are soft markets necessarily antagonistic to captive utilisation? At least in recent times, that piece of conventional wisdom seems to carry little weight. Clearly, organisations already using captives, especially the owned, single-parent variety, are unlikely to abandon or mothball their captives simply to take advantage of short-term price considerations. Risk managers of such programmes understand only too well the long-term benefits of captives.

Competition

Group or association captives with memberships comprised of smaller and middle-market companies are probably more likely to be negatively affected by soft markets, as some participants look to traditional products for short-term savings. However, in our experience, the movement of customers out of group captives and back to conventional insurance products during soft markets has been significantly less than the conventional wisdom might suggest.

While some customers may opt to selectively purchase insurance products to take advantage of opportunistic savings, their commitment to the captive approach remains secure. Indeed, defections from captives to traditional insurance providers during soft markets occur at a much lower rate than the movement and replacement

of products at carriers.

Much of this ‘stickiness’ is directly attributable to the mind-set that led companies to choose captive alternatives in the first place. Organisations that participate in captives do so because they have made a strategic decision to enter a layer of financial responsibility that makes them greater participants in the risk management equation. This is not a decision that is made lightly.

Captive participation also prompts beneficial changes in the ways captive owners view their business processes and operations. Sharing a higher percentage of their own risk prompts a much stronger focus on risk management activities aimed at reducing losses and controlling claims costs.

While this is especially true in the single-parent captive universe, a focus on loss reduction is seen as a particular virtue in group captives, where all members have vested interests in the quality of the captive’s overall loss experience. Actions taken to improve loss frequencies will flow back to all captive participants in the form of cost savings and dividends.

Proving their worth

So, are captives essentially bulletproof when it comes to the impact of soft markets or even significant market disruptions? While no risk transfer tool can ever be immune completely to outside influences, the outlook for captives is becoming more bullish all the time.

You need only review the expanding universe of captive domiciles to realise that the trajectory for captives is strongly

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positive. In particular, we are likely to see continued growth in US captive domiciles as individual states position themselves to become more business friendly and to attract more highly paid, white-collar jobs. We will also see captives getting involved in broader categories of risk, such as the provision and management of employee benefit programmes.

Given all the benefits of captives, we believe the non-traditional market will continue to outpace the traditional markets in terms of growth. So, overall, the future for captives is very bright. Whatever happens in the insurance markets or in the broader economy, captive utilisation will only become more extensive and influential in the future.



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