TAKING THE EDGE OFF A 'HARSH MARKET'

Todd Cunningham of Zurich considers why the captive market is at present 'harsh', and how insurers should deal with it

Captives have always played an important role in large corporations' risk management strategies. They can be a vital bridge between self-insurance and risk transfer, serving as platforms to optimise the total cost of risk to the parent organisations.

Now, with risks on the rise and insurance providers feeling the pinch, the single-parent captive is even more critical in taking the bite out of what I refer to as harsh insurance market conditions. Why is it a 'harsh' market, and not a 'hard' market? Unlike historic hard markets, there is still plenty of capital seeking returns from risks uncorrelated with the equity markets. However, there is a unique and rather perfect storm of risks in play restricting the amount of capital insurance providers are willing to assign, leading to a supply shortage that has driven up price of risk transfer. This article will address those emerging risk patterns, reinforcing the need for increased sophistication in the captive market and offering some solutions to captive managers seeking to mitigate this challenging risk landscape.

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A changing landscape

Clearly, the US court system is a big contributor to increasing total cost of risk. Unprecedented awards, a weaker negligence standard, evolving trial attorney tactics and more sympathetic jury pools across more venues have affected several areas of risk.

Premises liability has become a hot topic over the duty to protect people in your building or parking lot. In April 2019, a Georgia jury returned a verdict of $70m against a grocery store chain for failing to provide a secure parking lot. A veteran was car-jacked in a grocery store parking lot, surviving several gunshot wounds and helping to identify his attackers. The grocery store was in a high-crime neighbourhood and management had hired an armed guard to protect the store and patrons. At trial, the plaintiff attorney identified this as a key fact in implicating the store in its failure to protect patrons in the parking lot, convincing the jury to return with a $70m verdict.

In commercial auto, more frequent accidents are driving verdicts so large that the term 'nuclear' is often used to describe them. At an American Trucking Association's industry conference, renowned defense attorney Charles Carr presented a David Letterman-style top 10 list of trucking losses, ranging from $30m on the low end to a whopping $281m awarded by a Texas trial court.[1] Negligence is no longer the arbiter of fault. Plaintiff attorney tactics designed to stimulate survival instincts over logic in jury members, sometimes referred to as a 'reptilian brain strategy', have been deployed to convince jurors it is their duty to protect their communities from the predatory trucks stalking their streets. Indeed, following rules and regulations is no longer a strong defence. A 2018 case involving a trucker legally parked along the side of

the road and an accidental collision with a cyclist resulted in a jury award of $25m.

Medical malpractice cases are driving the need for additional premium, depending on the specific venue. In a 2017 case, a jury in Cook County, Illinois, awarded a verdict of $48m against a hospital system for a brain-damaged baby.[2]

Further, employment practices liability is increasing as discrimination cases are on the rise and have the potential to create large class actions in cases of common cause and effect.

Finally, directors & officers (D&O) liability continues to experience increasing pressure, as described in a 2019 study by Woodruff Sawyer that cites rising securities class actions as a cause.[3]

Compounding the frequency and severity of losses impacting liability lines are historically low interest rates and an inverted yield curve. To the degree that long-tailed liability reserves are discounted, there is a potential for shortfalls when the time comes to pay claims.

Unfortunately, news on the property front isn't much better. Increasing ocean temperatures, more frequent and intense storm activity, flooding, hail and droughts signal the realities of a changing climate. The good news is the insurance marketplace is well equipped to model and anticipate many of the impacts of these changes. Preparedness also resonates among municipal planners, many of whom are undertaking concerted efforts to build resiliency. A long, soft-market period has ended. As a result, rates, particularly in zones subject to natural catastrophes, are going up fast, with double-digit rate increases becoming the norm.

A powerful tool, if used right

Without a doubt, the complexity of issues facing the captive manager is at an all-time high. The bar has been raised both in terms of maintaining the capital of the captive, as well as demonstrating to the parent organisation how the captive can play an important role in mitigating emerging risks to the organisation. Properly empowered, financed and staffed, the captive is a powerful and efficient basis for strategic decision-making and for managing corporate risk in uncertain times. As discussed in the Marsh 2018 Captive Landscape Report, captives now appeal to stakeholders across the organisation, including the C-suite.[4]

Traditional risks, such as property, general liability and workers' compensation, have been the mainstays of captive insurance strategies. The industry has matured and grown to include trusted partners who support these efforts. Managing agents, fronting carriers, reinsurance markets, financial institutions, claims administrators and risk analysts are just a few of the partners captive managers need to be successful. While the traditional risks are well-known, as changes in the traditional insurance market occur, captive owners will be challenged to take on more risk. This may come in the form of higher retentions for auto, for example, or in broader coverage like non-damage business interruption.

> "A key part of dealing with a harsher insurance market is determining an appropriate level of risk retention"

Like a third-party insurer, a captive is uniquely positioned to map and benchmark risks, to trend and develop losses, to create new products and to manage claims. Going forward, captives have an important role as risk clearing houses for their parent organisations. By aggregating both exposure and loss data, the captive can apply analytical tools to determine financial impact across multiple lines of business.

Simply stated, risk generates uncertainty, and uncertainty impacts valuations. Financial risks to cashflow, income and assets are generated by many operational activities. These activities are critical to the success of the enterprise whose risks may or may not be insurable in the market. Given current market trends, the cost of insurable risks is rising. For those risks not within an insurer's risk appetite, there are opportunities for the captive to step up and provide solutions.

A key part of dealing with a harsher insurance market is determining an appropriate level of risk retention. In designing the captive structure, determination of risk retention needs to align with the parent's capital structure, free cash and risk tolerance of key stakeholders. In a stressed market, it is important to have frequent dialogue with the finance team to maintain alignment. Where there is a disconnect between the market price and the risk manager's valuation of the risk, the captive is a good means to resolve this.

The availability, capacity, cost and duration of reinsurance are factors that should be considered when making strategic decisions around the mix of business in the captive. Reinsurers often take a different view of risk once in a captive because these underwriters believe the alignment in risk is greater from a captive – provided it isn't ceding 100% of the risk. Once established, these reinsurance relationships can be invaluable in supporting a sustainable captive strategy for the long term. Creative structures, such as multi-year, multi-line reinsurance, cross-class aggregate stop loss and bespoke risk financing, are just some of the solution sets available.

A recent example of this creativity involved a significant captive aggregate retention across 13 lines of coverage, blended with specific excess of loss coverage over four lines. The reinsurance was written as a three year policy on a non-cancellable basis and involved multiple reinsurers participating on a quota-share basis. The protection offered innovative coverage grants, such as brand protection and product recall.

In another recent case, the captive bought significant integrated risk reinsurance capacity across nine lines of business. This transaction involved more than 20 reinsurers, signalling that the market is willing to accommodate these transactions when properly structured and priced.

In both of these cases, the effect of removing any vagaries in the traditional market was mitigated.

Given today's troublesome trend in liability insurance and the seemingly accelerating pace of change in weather patterns, the level of sophisticated solutions available to the captive manager is expected to continue. These will include insurance-linked securities, cat bonds, sidecars, multi-year/multi-line, cross-class aggregate stop loss and parametrics. More will follow as the need for financial certainty in an uncertain world remains and intensifies.

[1] *Carr, Charles, NAFC Session 1 Nuclear Verdicts, Carr Allison, October 3, 2016.*

[2] *Kelly, Jamie, Cook County Record, Jun 30, 2016*

[3] *Woodruff Sawyer & Co., Looking Ahead 2019, D&O Market Update, September 9, 2018*

[4] *Charnley, Ellen, Securing Your Future with a Captive, Marsh, June 2019*