

A captive audience

The slowing growth in new captive formations does not mean risk managers' enthusiasm for this form of risk transfer has waned.

By Garry Booth

The sustained growth of the captive insurance business is counterintuitive at first glance. The long-term trend among big businesses is to outsource non-core functions. But when it comes to risk management, corporations are increasingly bucking that trend and continuing to buy less insurance from external sources.

Although the growth in the number of captive insurance companies slowed in 2005 (see table), the long-term trend is for more captives writing more and varied business.

According to a recent research note from consultancy Advisen, the number of licensed captive insurance companies within the top 10 domiciles grew by less than 4% in 2005 to 4,157 from 4,004. By comparison, new captive formations shot up between 2001 and 2003, when insurance premium rates increased sharply. Rating agency AM Best reported that new formations increased by 50% between 2002 and 2003, for example.

Behind the numbers

But most captive observers say new captive formation statistics ignore a more hard-to-measure trend in captive usage. They believe there is a tendency for corporate parents to place more business into their established captives or for corporations to increasingly revive dormant captives.

David Hertzell, a partner with UK law firm Davies Arnold Cooper, and head of the special captive interest group at UK risk management association Airmic, says that the bare captive formation numbers also do not show the inexorable rise of protected cell companies (PCCs). These structures allow several different companies to use the same captive. Their individual liabilities are separated from one another into so-called cells within the captive.

"If you could look at captive premium income numbers from existing operations and also include the new premiums coming through individual cells, you would get a very different picture," Hertzell says.

Stephen Cross, chief executive at captive management company Aon Captive Services Group, agrees. "There's been a huge growth in the use of PCCs and some

individual cells are bigger than many typical captive insurers," he says. According to a recent report from Aon there were 300 active cell captives in 2004, with more than 1,200 cells between them.

The gathering strength and diversity of the captive industry is partly a reflection of heightened volatility in the traditional insurance market. Insurance buyers are increasingly unwilling to put up with big swings in insurance prices. "When an insurance buyer is faced with 200% premium rate increases year on year, it makes budgeting very difficult," says Hertzell. "One of the main reasons for forming a captive is to achieve a smoothing effect on insurance spending."

Cross says that an influx of capital into Bermudian start-up companies after last year's hurricane season has dampened the effect of big catastrophe losses on prices. "But if we have another active hurricane season this year, capacity will retract again and prices will go up," he warns. "And when prices go up, insurance buyers go out looking for alternatives."

Henry Witmer, who heads up the alternative risk transfer group in the property/casualty division at AM Best, agrees that

the pricing cycle plays a big part in influencing risk managers to use captives. But he says this only happens in certain lines of business, rather than the insurance market as a whole. "Many want better control of a programme. Others have determined that a captive will offer the means to have specific attention addressed to their needs, often because of their unique niche," he says.

Another reason for the continued interest in captives, Witmer believes, is that senior managers of corporations now want a better understanding of the risks facing their company, so they can control losses and improve risk management. "This, plus avoidance of the vagaries of the insurance market, leads to long term stability of coverage and pricing – with the benefit of return premiums if experience is favourable," he says.

Corporations are also discovering that forming a captive gives them a better link to reinsurers – usually the ultimate providers of their risk capital.

"By operating a captive, a corporation is saying to reinsurers, 'Here's my risk retention. I'm carrying and managing that exposure effectively because it is in my interests to do so,'" says Dave O'Connor, a consultant at actuarial consultancy firm

The world's leading captive domiciles

Ranked by number of captives

Domicile	2005 captive numbers	2004 captive numbers	Net gain/loss	Gain/loss %
Bermuda	987	1000	-13	-1.3
Cayman Islands	733	693	40	5.8
Vermont	542	524	18	3.4
British Virgin Islands	383	346	37	10.7
Guernsey	382	379	3	0.8
Barbados	301	290	11	3.8
Luxembourg	208	219	-11	-5.0
Dublin	207	214	-7	-3.3
Turks and Caicos Islands	166	164	2	1.2
Isle of Man	165	175	-10	-5.7
Hawaii	158	147	11	7.5
South Carolina	122	106	16	15.1
Singapore	60	57	3	5.3
District of Columbia (US)	59	40	19	47.5
Nevada	58	39	19	48.7
Arizona	53	39	14	35.9
Average			10	3.6

Source: Aon Alternative Views, March 2006

Best global captive domiciles

Best overall captive domiciles

Bermuda
US
Cayman islands
Ireland
Also mentioned: Guernsey, Malta, Hawaii, Barbados

Best up-and-coming domiciles

For various qualities

Tailored regulation
South Carolina
Malta
Also mentioned: Nevada, Hawaii, Gibraltar

Accessibility

South Carolina
Malta
Also mentioned: New York, Hawaii, Gibraltar

Cost efficiency

Malta
South Carolina
Also mentioned: Nevada, Hawaii

Source: Reactions Research

Key all tables

Winner
Highly commended
Commended

Tillinghast. "That's a starkly different message to handing over the premium to an insurer and walking away."

Going against the grain

Forming a captive is not an easy option, however, and self-insuring goes against today's corporate trend for outsourcing. Some believe companies should not rush into forming a captive simply because their premiums went up higher than they would like.

"There is a regulatory burden and you have to balance those costs against the benefits," says O'Connor. "If you focus on long-term cost stability and risk management objectives then you'll get the right answer. If you're basing your decision on the market cycle, the frictional costs mean it doesn't make sense."

Nevertheless, getting access to captives is becoming easier. Captives were once the preserve of big corporations, but with the introduction of PCCs, the entry level is getting lower. The ready-made PCC structure on offer from captive service providers means that small-to-medium-sized companies can afford to take the captive route. It also means that bigger companies can be more creative with their risk financing. Multinational companies, for example, can insure operating units separately within different cells of a PCC.

Best captive domiciles by region

Best domiciles in the US

For various qualities

Tailored regulation

Vermont
South Carolina
Washington DC
Also mentioned: Washington, Hawaii

Accessibility

Vermont
South Carolina
Washington DC

Cost efficiency

Vermont
South Carolina
Nevada
Arizona

Protected cell legislation

Vermont
South Carolina
Washington DC
Delaware

Best domiciles in Europe

For various qualities

Tailored regulation

Ireland
Guernsey
Gibraltar
Also mentioned: Isle of Man, Dublin, Luxembourg

Accessibility

Ireland
Luxembourg
Dublin
Also mentioned: Malta, Switzerland

Cost efficiency

Isle of Man
Ireland
Malta
Guernsey
Gibraltar

Protected cell legislation

Guernsey
Ireland
Isle of Man

Source: Reactions Research

Guernsey was the first to introduce PCCs. It brought in PCC legislation nine years ago. Now cell captives are the fastest-growing area of the captive market and more than 30 domiciles now have PCC legislation.

Cell captives are used to write a wide range of risks, including insurance for product warranty, credit, life, mortgage, employee benefits, and even high net worth individuals. The Cayman Islands, for example, has attracted a large number of cell captives from the US healthcare industry, notably hospitals and physician groups.

Cross at Aon says the introduction of PCCs has greatly improved access to the

Best domicile in the Caribbean

For various qualities

Tailored regulation

Bermuda
Cayman Islands

Accessibility

Bermuda
Cayman Islands

Cost efficiency

Bermuda
Cayman Islands
British Virgin Islands

Protected cell legislation

Bermuda
Cayman Islands

Best domicile in the Middle East/Asia

For various qualities

Tailored regulation

Singapore
Hong Kong

Accessibility

Singapore
Hong Kong

Cost efficiency

Singapore
Hong Kong

Protected cell legislation

Singapore
Hong Kong

Source: Reactions Research

"For those who feel the costs and complications of a captive are too great, there is the rent-a-captive or cell captive avenue, which can serve well, especially as an entry-level approach."

Henry Witmer, head of the alternative risk transfer group in the property/casualty division at AM Best

captive market. "People used to say that only companies with revenues of more than \$1bn could benefit from a captive operation," he says. "Now we say that a company with \$250m in sales, and a specific risk issue, should consider a PCC." One example of such a company, says Cross, is a manufacturer of medical devices that, by definition, has a high product liability risk exposure.

If a company, non-profit firm or governmental organisation sees a benefit in ►

Best international captive management firm

Aon
 Marsh
 International Advisory Services
 Novus Management
 USA Risk Group
 Also mentioned:
 Sartor Resources, Sogecore
 Source: Reactions Research

forming a captive or group captive, there is almost no excuse for not being able to form one these days. "There are numerous captive managers and consultants with in-depth expertise in forming captives and operating them," says Witmer at AM Best. "The costs are very reasonable for individual and group captives, given a minimum size to make economic sense," he says. "For those who feel the costs and complications of a captive are too great, there is the rent-a-captive or cell captive avenue, which can serve well, especially as an entry-level approach."

Competition among captive domiciles is keener than ever, with more domiciles providing greater choice for captive owners. Twenty years ago there were fewer than 15 captive domiciles to choose from. Now there are around 65 domiciles worldwide for would-be captive owners to consider.

The market is still dominated by a handful of long-standing captive locations, however. The top 10 domiciles account for around 85% of all captives.

But some newer domiciles, especially US states, are growing rapidly. In only five years, South Carolina has become the 12th-biggest domicile. It had 122 captives by the end of 2005. Nevada, Arizona and the District of Columbia have also established themselves as important captive centres.

Business has been brisk. US companies that were previously reluctant to form a captive offshore can now do so onshore. In 2005, Arizona added 14 new captives, and the District of Columbia and Nevada added 19 each.

Insurers and reinsurers have contributed little to the onward march of the global captive movement, however. With some notable exceptions (see survey results) insurers and reinsurers have begun to shy away from captive-related business. This could eventually be an obstacle to growth in the captive industry, say some insiders.

Captives need fronting services, especially when writing business in jurisdictions with tough licensing requirements. But since September 11, insurers that front for captive insurance companies have come under pressure from rating agencies over the credit risks they are

Best insurers and reinsurers

For services to captives

Best captive fronting insurer

AIG
 Ace
 Old Republic
 Zurich
 Royal & SunAlliance
 Also mentioned:
 Liberty

Best captive reinsurer

Swiss Re
 Lloyd's
 Munich Re
 Also mentioned:
 XL Re, Generali

Source: Reactions Research

taking on. Unless the captive has its own credit rating or a letter of credit from its parent, rating agencies could penalise the fronting company.

Witmer says that there is a limited number of insurance companies that are willing to provide fronting services to captives, and that the count is declining. "This leads to frustration with the rising costs for fronting and collateral requirements, coupled with loss of control of certain aspects of the programme," he says.

As with open-market insurers, captives also need reinsurance capacity. But reinsurance is becoming harder for captives to access as reinsurers focus resources on their core businesses. A recent survey carried out by the specialist website *captive.com* found that 43.5% of captives have been forced to change reinsurers in the past three years. Of these, 60% said it was because of high costs, 30% said it was because they could no longer get cover from their existing reinsurer, and 20% said it was because terms were too onerous.

In happier days a captive would have routinely written high programme limits and then reinsure a lot of it in the open market. Today, insiders say it would be more difficult for any captive to write \$400m of business and then reinsure \$350m of it, for example.

Witmer says a wide variety of companies will write excess-of-loss reinsurance or aggregate stop-loss covers on a treaty basis for captives, but other types of coverage are dwindling. "Far less frequently, facultative covers and quota-share programs can be arranged with a commercial carrier," he says. "The recent trend in reinsurance is for the captive to take significantly higher working layer retentions so that the reinsurer is further removed from the underlying risks."

Constraints on fronting arrangements and a tighter reinsurance market are unlikely to stop the progression of the captive movement, however. Not only is there growth left in mature captive markets, as

Best captive service providers

Best captive law firm

Conyers Dill & Pearman
 Appleby Spurling Hunter
 Baker & McKenzie
 Also mentioned:
 Morris, Manning & Martin, Stevens & Lee, SJ Berwin

Best bank/letter of credit provider

HSBC
 Comerica
 Brown Brothers Harriman
 Also mentioned:
 Wachovia, Deutsche Bank

Best captive asset manager

Brown Brothers Harriman
 HSBC
 Schroeders
 Also mentioned:
 Blackrock, Dwight Asset Management Company, Bank of Butterfield

Source: Reactions Research

demonstrated by the rise of US domiciles. New markets are emerging.

Until recently, Japanese corporations have been more reluctant than European or US companies to use captives. But, according to rating agency Standard & Poor's (S&P) which, like AM Best, rates captive insurers, the number of Japanese captives has been steadily increasing. It still stands at only 60 but parent companies span a wide variety of industries, including finance, general trading, automobiles, shipping, oil and travel. S&P recently rated captives formed by Japanese firms Mitsubishi and Mitsui.

Emerging risks are also contributing to captive growth, according to Cross at Aon. "Terrorism is a real worry for businesses and the captive market has proved to be an alternative source of coverage after many insurers withdrew," he says. US-based captives were included in the Terrorism Risk Insurance Act (Tria) programme in the US, and some companies with offshore captives established branch captives in Vermont specifically to access the coverage Tria provides.

Cross believes that an increasing emphasis on corporate governance means that corporations can no longer ignore risks simply because they are not insurable in the open market. For example, despite risk managers' concern about business interruption risks posed by a potential flu pandemic, traditional property insurance policies will not usually respond in such circumstances.

With a captive, a coverage programme can be tailored to meet such a need. "Investors will not allow businesses to ignore risks. They will demand to know what action you took to manage that risk," Cross says. "Increasingly, it is captives that are providing the answer." ●

