“What we are seeing is sustained growth and increasing interest by corporates in adopting and enhancing a captive strategy.”
What can the natural resources industries learn from the latest developments in managing captive insurance companies?
Willis’ Malcolm Cutts-Watson investigates.

Introduction - why use a captive more in a soft market?
The captive market is currently displaying counter intuitive behaviour. Many of the traditional indicators would lead one to expect a market in the doldrums, but what we are seeing is sustained growth and increasing interest by corporates in adopting and enhancing a captive strategy. So why is this?

Traditionally a soft insurance market inhibits the use of captives as the financial advantage of retaining risk versus transferring it to insurers is squeezed by competitive market pricing. Capacity remains generally available, while low interest rates mean that premium funds held by the captive earn only a modest return. There is continued scrutiny of offshore structures (where many captives are located) which may be perceived with suspicion as tax avoidance vehicles. And finally, the global move to risk based regulation for the insurance industry (following that adopted by financial institutions) is raising solvency capital requirements and making the running of a captive more burdensome. So there must be compelling reasons for companies to go down the captive route.

Risk means different things to different people
There will always be a difference between an energy company’s perceptions of its own risk compared to that held by the market. This can translate into different pricing models and perceived value in retaining the risk (and associated premium). Large global energy players often possess stronger balance sheets than the markets and their captives hold investment grade credit ratings, thereby mitigating any counter party default risk. There can also be uncertainty as to how markets would respond to notification of a major loss. Major energy companies prefer their joint venture partners to access available market capacity whilst using their own captive to retain their proposition of any shared risk. All of this encourages energy companies to pursue a captive strategy.

Captives act to smooth operating company balance sheets
Operationally a captive adds real value as the repository of a group’s retained risk (and associated funding) thereby avoiding operating companies having to carry this on their balance sheets and facilitating the optimum risk financing strategy through cost efficient transfer of risk in excess of a group’s risk appetite. It also facilitates the collection of underwriting and loss data which allows informed decision making and improved governance of risk.

These strategic, operational and, on many occasions, financial drivers remain valid even during a soft market and are responsible for captives’ popularity.

New financial centres encourage captive growth
As at year end 2013 there were 6,342 captives recorded worldwide, an increase of 4% on the previous year. Whilst 2014 numbers are not yet available, our best estimate is these will top 6,700, representing a 6% increase. The vast majority of this growth has occurred in US States whilst the more traditional captive centers such as Bermuda, Cayman Islands and Guernsey have shown nil net growth despite a number of new formations as mature captives have been wound up or merged. What the statistics do not give a feel for is the volume of premium underwritten by captives and how much of it is retained.

What we do know is that publicly available data reveals 60% of the captive market wrote USD85 billion in premium in 2013. If we extrapolate this, taking into account the inclusion of the larger captives in this sample, we can suggest that total captive premiums worldwide are now in excess of USD100 billion, some way higher than most commentators’ estimates; energy industry captives would certainly form a significant proportion of that total.
Again, capitalization figures for the total captive market are not publicly available, but working on the assumption that most captives underwrite conservatively at a margin of 33% to capital, we estimate that global captive market capital now exceeds USD300 billion.

### Total Captives Worldwide

<table>
<thead>
<tr>
<th>Year</th>
<th>Captives</th>
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<tbody>
<tr>
<td>2006</td>
<td>4,951</td>
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<tr>
<td>2007</td>
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<td>5,831*</td>
</tr>
<tr>
<td>2012</td>
<td>6,125*</td>
</tr>
<tr>
<td>2013</td>
<td>6,342</td>
</tr>
<tr>
<td>2014</td>
<td>6,700**</td>
</tr>
</tbody>
</table>

*Restated **Willis Best Estimate

Source: Business Insurance Survey published March 2014/Willis

### Emerging trends impacting the captive market

#### Captive expansion in Asia

Interest in captives has exploded in Asia, and in particular China where state owned enterprises are embracing the captive proposition as a solution to the challenges faced by rapid investment in assets outside China and the desire to consolidate insurance purchasing. The captive is an effective tool to capture key management information to enable the creation of an optimum risk financing strategy, one which incorporates the most cost efficient balance of retained/transfered risk and supports both centralised decision making and the insurance purchasing process. This is of huge value and many newly-formed energy company captives are initially not retaining any risk but acting as a conduit to the markets whilst collecting this key data for future analysis. We therefore expect to see continued announcements of captive formations in the region.

#### The need to demonstrate value

Owners of captives are facing an increasing challenge (both internally and externally) to demonstrate the value the captive delivers. This scrutiny would appear to be legitimate, in light of demands for capital elsewhere in the company and the fiscal authorities’ interest in related party transactions. Captive boards and shareholders need to develop a set of metrics to measure strategic, financial and operational value generated by the captive and promote the role of the captive to all stakeholders. For newly formed captives, it is the responsibility of the Board and shareholders to create a clear road map for the captive to follow to ensure the captive strategy is properly aligned to its parent’s business needs and the captive is being utilized to its full potential. A template of such a road map is shown in the diagram overleaf.
Increased regulatory oversight is leading to better management and governance of risk

The generally increased regulatory oversight of the insurance industry in recent years includes that of captives. In Europe, Solvency 2 is leading the charge but other jurisdictions are adopting their own risk based regulatory regimes. Initially there was resistance from captive stakeholders to captives falling under the same regulatory system as commercial carriers but as the date of implementation of Solvency 2 (January 1, 2016) approaches we have detected a marked change of attitude — the certainty of adoption has focused minds, and robust implementation plans are now well underway. Solvency rules for general insurance are now well understood, and captive boards have had adequate time to amend their business plans to ensure compliance with the new requirements.

The value in properly understanding all the business risks a captive faces (and how these are managed) is now being recognized by captive stakeholders. The investment in creating an individual risk management and governance framework for each captive is increasingly being seen as a worthwhile exercise and provides further evidence of the value that a captive delivers. However, increased detailed reporting to regulators and other stakeholders remains a challenge.

Whilst it is expected that the industry will develop solutions for regulatory compliance to the new regime, it is difficult to see any real value created by the enhanced reporting demanded in the regulation, and furthermore at the same time it inevitably adds cost; in our view it all amounts to is increasing demands on captive management teams. Captive owners will need to assess what expertise is required to ensure that best operational practices are being adopted and decide whether this is delivered more effectively in-house or through external appointments. Again this will add cost, but the value generated by operating the captive efficiently and understanding its risks should outweigh the cost downside.

Growth in micro captives

Whilst not directly relevant to energy companies, the growth in micro-captives demonstrates that the value of captives is not limited to only the largest organisations. Protected cell companies, where a series of segregated underwriting accounts operate within one corporate entity, are now established corporate structures and represent the fastest growing segment in the captive marketplace. We can see a role for such a vehicle for an energy company with diverse business interests and

![Diagram](image_url)
business partners as a means of segregating and funding risks whilst protecting the interests of the different parties.

This technology has further evolved with the use of protected cells as SPVs to facilitate the transfer of insurable risk to the capital markets. The emergence of the capital markets as a source of increased capacity is well documented.

To date, this has primarily been accessed by insurance carriers who have securitised a portfolio of insureds’ risk as an alternative to traditional reinsurance. Many of these transactions are prefunded, thereby removing any credit default risk and so the risk bearing capacity of these micro-captives could be significantly increased. To date these transactions have focused on natural catastrophe risk, as the ability to model and price the risk already exists. Subject to modelling capabilities, there is no reason why the range of risks could not be extended to a basket of all risk property protection.

It is quite possible that in the near future it will become more common for energy companies to access (re)insurance protection from the capital markets via their own captive directly, or buy collateralized reinsurance from an SPV or cell company. To do this, the capital markets investors will need to be comfortable with the absence of a commercial carrier to settle claims. In addition, the cover will become more useful if it expands beyond well modelled named perils (natural catastrophe risk) to include the broader coverage found in an all risk cover.

Broader, emerging risks
Captives are writing a broader range of risks, including emerging risks that the insurance market may be reluctant to underwrite. Cyber risk is the obvious example but supply chain risk, environmental impairment and even reputational risk are covers now being written by captives. In many cases the captive is acting as an incubator, holding risk until the market has sufficient data to model, price and accept the risk. In other cases, the captive board is comfortable retaining the risk and forms part of a predetermined increase in risk capacity as part of execution of a strategic roadmap. Increasing the spread of risk in a captive leads to more efficient use of capital as the divergence and non-correlation of risks offsets any additional solvency requirements.

Increasing choice of captive domiciles and associated competition
Almost every month it seems that another jurisdiction is announcing it is setting itself up as a captive domicile. US States and Caribbean islands form the majority of new entrants, but the shift in economic power eastwards has seen Hong Kong and mainland China enter the fray. Given the increasing concentration of Asian companies in the Fortune 1000, we can expect to see significant growth in domiciles in the region. Singapore, Hong Kong and mainland China (in particular the Free Trade Zones) should all benefit.

All domiciles are under pressure to adopt international core principles of insurance regulation to meet and maintain world economic bodies’ accreditation. However, the key to achieving a competitive advantage will be how domiciles implement a proportional response and adopt a pragmatic interpretation of global standards in response to the unique risk characteristics of captives, where consumer protection and threat of market instability are much lower than the commercial segment. The classic bifurcation remains; onshore domiciles offer reputational protection but presents a more onerous regulatory regime compared to the greater flexibility of operating offshore with its associated reputational concerns.

Bermuda has developed an innovative proposal to respond to these challenges by suggesting onshore style regulation for commercial carriers and a lighter touch regime for captives. If this tactic proves acceptable to the EU, we should expect to see this regulatory model replicated elsewhere around the world.

Implications for captive owners
So what should owners of existing or future captives make of all these developments?

— Captives continue to be a valid risk financing tool and should be considered as an integral part of any review of the company’s risk financing strategy and implementation of its global insurance programme.
— The capture of quality underwriting and loss data in a captive has never been more important, as this enables informed insurance purchasing decisions and differentiates the risk to the insurance market.
— The choice of location, corporate structure, risks and (re)insurance programme structure to be included in the captive business plan have never been more critical, providing the greatest opportunity for success. Captive owners should prepare a 3-5 year roadmap to ensure key strategic, financial and operational drivers are achieved and the captive’s operations are realigned to the group’s business needs on a regular basis.
— Captive owners should expect challenge. They should therefore establish KPIs against each of the key milestones of the roadmap and should monitor the captive’s performance in achieving them. They should be prepared to engage with critics and promote the captive internally by articulating the value that their captive generates.
— To maximize their chances of success, captive owners should deploy a combination of the analytical capabilities, market awareness and captive utilization advice available from their broker or consultant.
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