Licensing me softly

The prolonged soft market aside, captives aren't doing too badly right now

The captive insurance industry has been at the behest of a soft market for a considerable amount of time. Peter Child, director at Artex Risk, says: "The current soft market is unprecedented."

"[It's been a] perfect storm of a comparatively low level of catastrophic losses and the desire of new capital to find investments that have provided a decent return over the last few years and present risks that are uncorrelated with more traditional asset classes."

"I have no doubt that at some point things will change, as either the value of catastrophic losses spikes or alternative investments become more attractive, but, as always, it is extremely difficult to pinpoint when this might happen."

Edward Koral, a specialist leader at Deloitte in Vermont, also believes that a few catastrophic losses could change the situation, but he suggests that the market has also seen non-traditional capital, such as catastrophe bonds, play an increasingly important role. He explains: "Persistently low returns on investments could drive higher premium pricing, but we've had low returns for years now, and we still have that soft market."

Leslie Boughner, chairman of Advantage's business insurance division, agrees: "While there have been limited catastrophes that would be the catalyst to change the market, it is only a matter of time."

Is the prolonged soft market having a negative effect on captive insurance? Shelby Weldon, director of licensing and authorisations at the Bermuda Monetary Authority (BMA), suggests it is having a more significant and negative impact on the commercial insurance market than the captive market. "We continue to see interest in the captive solution, despite a slower growth rate, particularly from emerging markets in recent years," he says.

Koral argues: "We just completed a very solid year in captive formations, in the midst of a soft insurance market."

He adds that the soft insurance market occurred alongside important developments in the tax treatment of captives and new corporate structures becoming available, which draw in smaller sized parent companies.

Boughner believes that soft markets are a routine variable affecting the insurance industry. He says: "The current cycle is no different than previous cycles and successful insurance entities adjust accordingly. Unsuccessful insurance entities react and find themselves unable to adjust when market conditions harden."

According to Koral, it has also encouraged organisations that previously might not have considered forming captives to look seriously at them to solve some very specific, and boutique-like, insurance and risk management problems.

There are many reasons companies choose to utilise a captive insurer to manage and mitigate risks. Weldon says: "In our experience cheaper rates are becoming less of a significant criterion when considering forming a new captive or continuing with an existing one. Companies are taking a long-term view of their risk management solutions and captives remain a viable strategy in this regard."

"The operational advantages of captives for maintaining insurance capacity and rate stability remain highly attractive to risk managers who are examining their enterprise risk management (ERM) programmes, and assessing what exposures should be insured or self-insured."

He explains that in Bermuda captives have been formed to cover a wide range of risks. He notes: "These have included extreme weather events in Africa, workers' compensation, property and product liability, as well as oil and natural gas drilling in Canada and auto liability insurance in Peru."

At full steam in 2015

Bermuda "continued to attract new captive registrations despite fierce competition from other domiciles and [the] continuing soft commercial market" in 2015, says Weldon.

In 2015, Bermuda registered 64 new insurers and reinsurers, only one fewer than 2014, with captive registrations defying the soft market conditions to achieve growth.

Child claims that Guernsey's predictions for 2015's captive results were "pretty much spot on". He reveals that Guernsey saw the total number of licensed entities increase from 797 to 804.

Although the number increased slightly, he notes: "There was a net nil change in the number of standalone captive entities, with 13 new formations and 13 surrenders. The growth came from new protected cell company (PCC) and incorporated cell company (ICC) cells."

Child adds: "We all know that the environment is not wholly conducive for new captive formations, so to be able to maintain the number of captives and grow the number of cells is encouraging for the island."

Boughner reveals that while Cayman Island captive formation figures were not as robust as some US domiciles, Cayman continues to experience growth in US healthcare.

He adds: "You have to consider that Cayman is not a centre for US micro captives, which will distort the numbers, but continues to be a captive leader when measured by premium and assets."

Cayman licensed 22 new captives in 2015, mirroring the number of captive formations in 2014.

At 2015's Cayman Captive Forum, Patrick Bodden, the Cayman Islands Monetary Authority deputy managing director, revealed that 189 new captives have been licensed between 2010 and 2015.

With 2015's captive formation figures as expected for most, Koral believes "it is a sign of returning marketplace confidence". Vermont also experienced strong growth in 2015, licensing 16 companies throughout the year.

He says: "A few years back you couldn't get companies to even look at new captive formations, even when initial cost benefit analysis showed a strong green light."

"But that's changed. Practitioners continue to innovate and think up new uses for captives, and there are fewer and fewer barriers to formation."

With captive insurance still popular, will 2016 be another positive year despite the prolonged soft insurance market?

Boughner responds with his own question: "Why would a company not have a captive?"

"A captive provides direct access to the reinsurance market. In hard cycles they can access capacity, which is not available as direct capacity. It can also retain risk within the captive at very attractive rates."

"In soft cycles the captive provides a vehicle to arbitrage the market at attractive costs. Neither option is available to companies who do not have a captive."

Koral believes nothing has happened over the past few years to make captives less attractive. He predicts that 2016 will be a strong year, and believes 2017 could be even stronger. He says: "The changes made to the small insurance companies provision in the US Tax Code are designed to root out potential abuses, but they also create opportunities for small to mid-sized companies that may have been waiting on the sidelines."

According to Weldon, it is the BMA's job to provide a stable supervisory environment that contributes to the interest in the captive solution.

He says: "If we continue to provide that kind of oxygen to the marketplace at the level of quality demanded of us, then there is every chance that this industry will continue to thrive."

Child, on the other hand, is against any predictions about the future, stating they are "fraught with danger".

But he does believe that "if the insurance management industry continues to diversify its activities and provides insurance-based solutions to a wider audience, there is potential for a better 2016, even if the environment is as challenging as it was in 2015". **CIT**