HOW A HARD COMMERCIAL INSURANCE MARKET IS DRIVING DEMAND FOR CAPTIVES

The hardening insurance market—amplified since COVID-19—is driving even more organizations to look at captive insurance solutions as market pressures increase. Six industry experts give their views.

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> **ANNE MARIE TOWLE, HYLANT**

The insurance market was hardening before COVID-19 but as the shockwaves of the pandemic continue to ripple around the world, coverage has become more restrictive, expensive and difficult, and increasing numbers of organizations are looking to captive insurance as a solution.

A feeling of being let down by the mainstream insurance market during the pandemic, coupled with an amplified drive for innovation and resilience, has created a willingness to try a new approach—and the captive insurance sector has risen to the challenge.

"The hard market has dramatically affected the demand for captives over the course of the last two years," says Anne Marie Towle, global captive solutions leader at Ohio-headquartered brokerage and risk management firm Hylant.

"We are seeing this with new formations, which have been outstanding the past year for many of the domiciles. In addition, current captive owners have made changes to their existing programs and are financing more risk through their captives. I believe this trend will continue well into 2022 and 2023."

Nancy Gray, regional managing director–captive & insurance management, Commercial Risk Solutions at Aon, agrees that the captive insurance sector is growing fast. Her organization has experienced a significant increase in captive utilization over the past three years as the market has hardened.

"Although there continues to be adequate capacity in the market, there have been significant price increases over the past three years, especially in certain lines such as property and fiduciary lines," she says.

"Clients have continued to experience increased premium rates, constrained capacity, and gaps in coverage. In addition to the increased utilization of existing captives, we had a significant demand for captive feasibility studies in 2020 and 2021 as compared with 2019, which has resulted in a substantial number of new captive formations."

Mikhail Raybshteyn, financial services partner at professional services firm EY, sums it up nicely when he describes the recent situation as "a rather interesting rollercoaster". He notes that the situation is more complex than it may at first appear. On one side he has seen a very large uptick in captive formations and captive program augmentations. On the other, he has seen companies deciding to close their captives or keep them "as is" due to reorganizations or other changes to the business.

"A lot of the movement depended on the industry and sector of a captive owner," he says. "Similar to prior years, unavailability and/or high cost of the coverage have driven developments, but an additional key factor was the rise in risks that were either not deemed material and therefore were uninsured in prior years, or that may have reached the top of the list (eg, cyber) due to severity of recent exposures."

Nick Hentges, chief executive officer of Captive Resources, which serves mid-market companies and is responsible for creating, developing, and overseeing member-owned group captives, has also seen some impact from the hard market.

In auto lines, for example, lines of coverage are tighter and it is more difficult to obtain higher limits from the policy issuing companies. Hentges notes that there will always be some insureds that are driven by a hard market to look at captive insurance—even some that do not take the time to fully investigate ownership and want to jump in as a short-term fix—but the captive insurance concept is not only a hard market solution.

"We've found that our group captive concept works well in either a hard or soft market—it's just a matter of educating brokers and prospective captive members on how it works in either type of market," he says.

"It's key to remember that a major goal of a group captive is to stabilize costs for its member-owners so they don't feel the volatile effects—the ups and downs—of the traditional insurance marketplace nearly as much."

Greater awareness

Education has long been a cornerstone of Captive Resources' work. "The interest in group captives has grown dramatically, and a big reason for that is we've been very successful over the last several years in creating greater awareness of group captives and the benefits they offer," Hentges says.

"We've invested heavily in educating brokers and discussing with their clients and prospects how, as a group captive member-owner, they can take control of their own destiny, and are able to significantly impact their premiums and other aspects of their insurance programs."

The business started over 35 years ago with a couple of captives. It took about 25 years for its portfolio of captive clients to grow to $1 billion of premium; that happened in 2012. Only five years later in 2017, total premium volume of the captives was $2 billion, and four years after that in 2021, premium surpassed $3 billion.

Hentges believes the current growth of the sector is only the beginning.

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"We think there's tremendous opportunity to double the number of members that are in our client captives in the next five years," he says. "That is due to the group captive concept and its value proposition being so compelling and more widely communicated today than it was 10 or even five years ago."

Speaking from a single parent captive's (SPC) point of view, Steve McElhiney, senior vice president and director of reinsurance at insurance management firm Artex, notes that the period from 2019 to 2022 brought a hardening market to a variety of lines of business including property, excess casualty, cyber, and D&O. Like Hentges, he notes that there has been a sustained migration from fully insured programs to captive programs over the last 10 years irrespective of market cycles, but he has seen a clear impact from the hardening market.

"The hardening market has been a considerable catalyst for companies investigating captive solutions, particularly in certain classes of business where capacity has become constrained due to carrier appetites," McElhiney adds.

"We have had success in establishing SPCs to access global reinsurance for such clients that have seen a withdrawal of traditional insurance capacity. Clearly, there is an active pipeline of interested captive clients across a variety of industry sectors."

Growth in many industries

McElhiney is particularly focused on SPCs for various engineered risk classifications where issues with traditional primary and excess capacity have been most acute, and Artex has been able to create captives to access global reinsurers for vital capacity.

Hylant has also been highly responsive—its team has grown and expanded in response to the demand for new captive feasibility studies, strategic reviews, and captive formation.

"We have been able to attract top talent to our team and rise to the occasion with developing strategic customized solutions for our clients," says Towle. "We have been excited by the demand and continue to strive to deliver value to each client in reviewing and optimizing their risk financing strategy."

Gray paints a similar picture: Commercial Risk Solutions prepared twice the number of captive feasibility studies in 2020 and 2021 as compared with 2019. These studies have resulted in a substantial number of new captive formations in 2021 with a large number of captive formations in process for 2022.

"This is in addition to the increase in the utilization of existing captives," she says. "As a result of the increased market pricing for the same risk, we are able to demonstrate the financial value achieved in forming a captive and retaining more risk in addition to the risk management benefits.

"For those organizations that continue to have good loss experience, there are true savings in total costs of risks by retaining more risk rather than paying increased market premium."

At Ophthalmic Mutual Insurance, growth has also been a key theme, partly because in some states where the company operates the market has limited competitors, and as a national company it can take advantage of those opportunities.

"A big change we have seen in our medical professional marketplace is the entry of private equity (PE) companies buying successful physician practices," says Tim Padovese, Ophthalmic Mutual's president and chief executive officer. "We have shown these PEs that our company is a great choice for their members."

Ophthalmic Mutual has been in a strong position to grow because it substantially increased its surplus in the past 10 years.

"We have pushed our company to be value-added with excellent risk management programs and an outstanding claims reputation," Padovese says.

However, he notes, while his company is in a strong position in some markets, many markets remain very competitive, putting pressure on pricing.

"Leveraging the other services we offer, such as risk management and claims excellence, has given us an upper hand in securing accounts," he adds.

Opportunities for innovation and captive careers

Towle notes that the growing demand for captives is a positive challenge, creating an opportunity for talent to grow and excel with innovation and servicing standards striving for excellence. However, she adds, there is a shortage of talent within the captives industry.

"Organizations need to think outside the box, apply technology to improve the client experience and train younger staff to step into roles to assist clients," she says. "This demand highlights the need for mentoring and training younger professionals in our industry and to establish a program for them to grow and learn the nuances within the captive industry.

"Investing the time in our people is so important in order to deliver and meet the demands of new captives."

Gray agrees that talent is a key issue.

"With the increased demand for captives and the resulting increase in new formations, we have an increased need for experienced captive insurance professionals," she says. "As many organizations are facing a war on talent, recruiting and hiring has become a much more challenging endeavor. For those individuals interested in a career in captives, there are a lot of opportunities."

CICA is playing a key role through its multiple initiatives to nurture talent—including the Amplify Women program, the NEXTGen initiative for young and new professionals committee, its partnerships with undergraduate universities and the International Center for Captive Insurance Education, its Mentorship Program, its annual conference and the CICA Student Essay Competition.

CICA is performing other key functions too.

"CICA is a real advocate for our organizations and provides regulatory and legislative support for our companies to operate," says Padovese. "It also collaborates with other organizations that support our industry for a coordinated effort, such as the Vermont Captive Insurance Association, MPL (specific to medical professional liability) and the National Risk Retention Association."

In McElhiney's view, the current hardening market presents an increased opportunity for CICA as new potential captive owners come to its website and events to explore captives through the educational sessions, networking, and the various sponsors representing all aspects of the captive business.

"I have made invaluable contacts through CICA, and the networking is always outstanding," he adds.

Key considerations

As Hentges has noted, some companies do not fully embrace the resources that are available and seek to plunge into the world of captives without deep research and understanding.

"They need to do their due diligence—to fully understand the concept and get to know the people that they'll be doing business with—including the service providers and even their fellow members," he cautions. "Trust and confidence are important elements among the parties involved in a group captive and should be present from the outset.

"They need to understand the potential benefits of course, but also the obligations of captive ownership. We spend a great deal of time educating brokers and prospective members—it's not an afterthought.

"Once we are sure that a prospective member has a good understanding and truly wants to be a part of a group captive, then we move forward with the numbers—do those make sense?" he explains.

He adds that a prospective company must be above average to qualify for one of Captive Resources' client captives.

"They're looking to recruit and admit companies that have well-defined risk management programs, and a proven track record of managing risk. Otherwise, a group captive is not likely to be a good fit for them or for the captive," he says.

Raybshteyn also highlights the importance of education, research and trustworthy guidance for any organisation seeking a captive solution.

"The key is to choose reputable consulting firms to assist with formation, feasibility, management, audit and tax implications of a planned structure," he says. "One of the key aspects is documentation, so doing everything right the first time saves many headaches in the future."

Padovese adds that capitalization is essential in forming your new captive, whether it is a standalone captive established by a parent, or a risk retention group.

"You cannot create a new organization unless everyone involved understands the risk, and the need for a detailed feasibility process involving actuary, reinsurance and committed stakeholders," he says. "Reinsurance is a central part of the formation process and an organization needs to show how it understands the risk and how it can control the outcome." ●