Captives: An Efficient Tool for Catastrophic Losses

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Editor's Note: Our much appreciated contributor **Anne Marie Towle**, a certified public accountant at JLT Insurance Management, offers her views on how captives can help their insureds with major catastrophic losses, as we have seen so many of late.

The year 2017 may become the most expensive on record for both insured and uninsured catastrophic losses—certainly in the United States. Reinsurer after reinsurer has reported multimillion and billion-dollar losses. Rate increases are sure to follow, and the only question remaining is "by how much?"

This comes after Mother Nature took a breather and natural disaster activity lessened following Superstorm Sandy. Memories faded, and businesses with significant property in multiple states were lulled, if not spoiled, by the steady decline in commercial rates. Although declining rates steadied from both primary insurers and reinsurers over the past 2 years, the recent natural disaster deluge will surely affect existing pricing.

In recent years, catastrophic (CAT) losses have mirrored natural disasters, which have become more severe and frequent. Consequently, as risk managers and other decision-makers in large and midsized organizations see their commercial rates rise, many will—or should—examine captive insurance companies as a foundational way to help mitigate excessive CAT loss-related expenses.

Unprecedented Losses

The National Centers for Environmental Information (NCEI) counted 218 weather and climate disasters in the United States where overall damages/costs reached or exceeded $1 billion since 1980. The total cost of these events is more than $1.2 trillion, which does not include losses from Hurricanes Harvey, Irma, and Maria or the recent California wildfires. These events will conservatively result in the neighborhood of at least $150 billion in additional losses.

Last year promises to be among the worst years ever for catastrophic losses, with NCEI counting 15 weather and climate events costing more than $1 billion through October. While the third quarter's catastrophic hurricanes that damaged the American Southeast, Texas, and the Caribbean seemed to dominate the headlines, the $1 billion events also included two floods, a freeze, seven severe storms (tornados and hurricanes), three tropical cyclones, a drought, and wildfires before the end of 2017.

Loss estimates for Hurricanes Irma and Maria alone started at around $100 million and have continued upward since. Californians continue tallying damages from recent wildfires, with early estimates between $4 billion and $6 billion.

There is more. Remember, this addresses just the United States and Caribbean. Natural disasters, from earthquakes and typhoons to landslides and floods, swept the globe from Mexico to Southeast Asia to South America during 2017.

Commercial Prices Will Spike

On the heels of multibillion-dollar insurance losses, premium increases in a variety of areas are likely. We anticipate premium increases from 3 percent to 10 percent across the board. We also expect more significant increases for anyone insuring property in windstorm-prone coastal areas. In the wake of a handful of 100-year and 500-year floods that occurred before and during the rash of hurricane landings, also expect additional premium for commercial flood insurance, which could be significant. As an aside, flood coverage in commercial markets is barely adequate to cover some global companies' flood risks.

Because property values keep increasing— not only in wind- and flood-prone areas but also in earthquake zones— it would be a surprise if commercial rates ever return to the low levels of early 2017. Expect increases in deductibles and possible changes to the terms and conditions or limits offered on the excess layers covered by commercial policies, either in place of or in addition to premium hikes. The damage to the insurance industry and its customer base is likely to manifest itself in difficult renewal conditions for anyone relying primarily on commercial insurance.

There are alternatives, however, for those who rely primarily or solely on commercial insurance. Captive insurance will play a part in many of these potential alternative solutions. An insurance strategy incorporating some or all of the following can help organizations, particularly companies with significant property exposure, to lower their total cost of risk.

Captives Work

Captives work especially well for large companies exposed to multiple natural disaster risks on a global or geographical scale. Medium and small companies can also enjoy the benefits of captives, if not quite as much of a benefit as that experienced by multinational companies. How much risk to put into a captive depends on an entity's variety of geographic risk and the limits it is comfortable retaining.

One thing that is clear through decades of watching them excel is that captives work well for primary retentions, excess layers, or a hybrid of both. Being creative in designing a program that is applicable and flexible for an organization is a hallmark of captives. A captive provides more overall insurance program control, making it easier to direct where risk is transferred and financed within an overall risk program. Accessing additional capacity through the reinsurance market and dictating coverage terms may be an easier solution with a captive as one option to defray costs. The alternative from the commercial markets is increased premiums or exclusions within the terms and conditions that may not be beneficial or cost-effective for an organization.

How might a company make the switch to retaining (or adding more) risk via a captive?

Organizations that retain a significant amount of risk via self-insurance, for instance, will need to do some soul-searching and analysis to determine if a captive is an optimal solution. Self-insurance has a direct impact on corporate balance sheets and operations with inevitable spikes from large events, while a captive can smooth the cost of risk over time. The return on investment should be evaluated through an actuarial analysis, and the risk capital relationship between a risk retention strategy versus a risk transfer strategy should be modeled, as illustrated in the following chart.

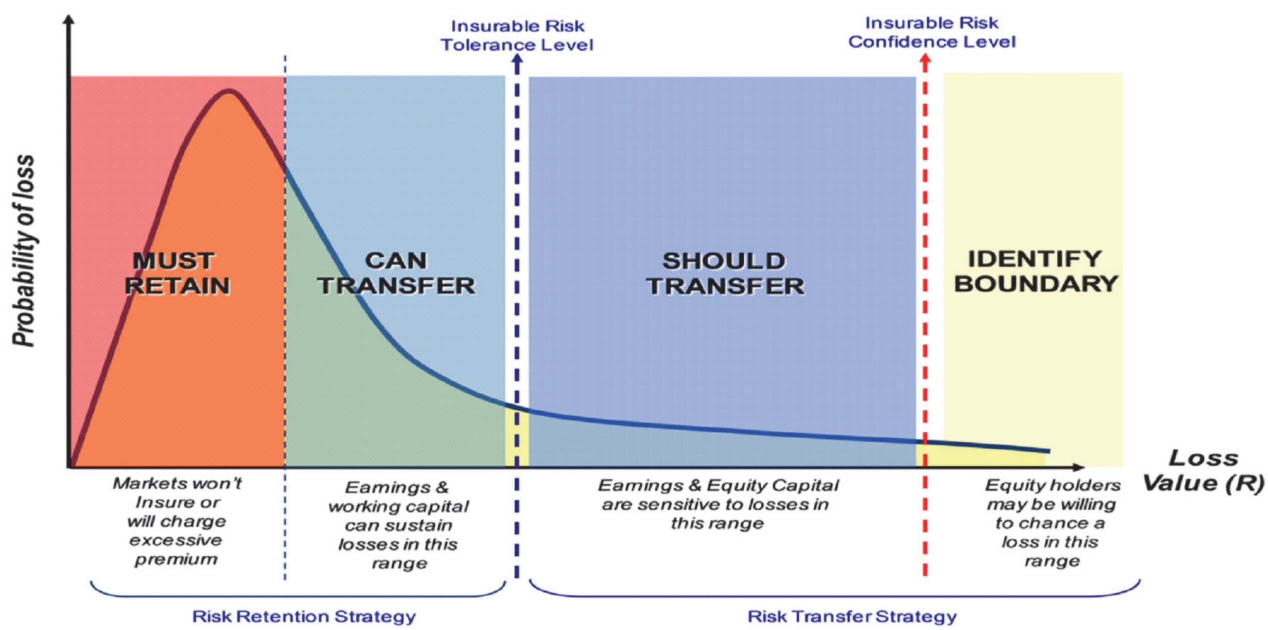
Times of catastrophic loss, such as in the immediate wake of Superstorm Sandy and Hurricanes Katrina and Andrew, are when organizations have paid more attention to captives in the past. In 2017, we received the same harsh reminders to refocus on risk appetite and strategy. For companies that retain a significant amount of risk, such junctures provide an opportunity to decide to either insure more risk in an existing captive or establish one to do the same.

Alternative Solutions

In the past, an increase in captives' risk appetite and formations has become apparent in a variety of ways.

- ✔ Captive-centric organizations seeking to reduce their total cost of risk typically start by retaining deductibles in their captives and then transfer risk through commercial solutions for some or the remainder of their primary and excess coverage. This approach can benefit insureds the most when claims are low or predictable and organizations have an enhanced focus on controlling loss costs.

- ✔ A less conservative organization might write a primary policy through its captive—for example, up to $5 million of loss—before reinsurance is triggered. Many insureds have high wind deductibles of 1–10 percent of the limits of liability before commercial insurance kicks in, resulting in $1 million–$5 million in out-of-pocket costs. Considering this, a captive-



Key	
Commercial Property Limits/ Flood, Earthquake, Windstorm	
Business Income	
Employers Liability/General Liability	
Business Auto Liability	
Excess and Umbrella	
Directors and Officers Liability	
Employment Practices Liability	
Fiduciary Liability	
Pollution Liability	
Builders Risk/ Contractors Professional Liability	
Cyber-Risk	
Crime	
Workers Compensation	
Possible Captive Coverage	

centric approach makes sense as a solution that can stabilize this cost of risk by funding the retention in the captive.

✔ Another tactic larger captives take is to assume a quota share percentage of excess risk—for example, 5–20 percent—up to certain limits of liability. This can result in better reinsurance pricing on the open markets. For instance, an organization builds a $100 million tower of insurance. It retains the first $5 million of the $100 million tower limit. It then reinsures around $5 million of the limit, participating in a quota share, or percentage, of excess risk based on geographic exposure and capitalization. Again, this approach can help stabilize catastrophic risk costs, especially during harder markets. The following chart and corresponding key provide a visual example of commercial coverage placements and indicate possible positions for captive excess quota share coverage.

✔ Smaller single-parent captives can also benefit by ceding risk or participating in a risk pool. Particularly, smaller companies most often share risk to access more cost-effective CAT risk options for protection.

Various Structures

As evidenced herein, there are various ways to structure a risk program with captive insurance as a focus. Many models are available to help organizations, including formulaic calculations to help structure or restructure an insurance program with catastrophic exposures. These calculations can be recommended and employed based on the number of exposed properties, geographical footprint, and balance sheet strength of the parent. At a minimum, a company should review its commercial limits of liability and policy exclusions annually and ask itself if losses are predictable or frequent and if it makes sense to transfer risk from commercial insurers to a captive. Through a captive, a company can benefit from controlling its own destiny and work to achieve a more favorable claims experience.

Revisiting how an organization controls the total cost of risk is an opportunity to use a captive (or create one) to its fullest potential, providing balance sheet stability and access to additional capacity. While prefunding a start-up captive with the necessary capital and reserves can be a temporary cash flow drain, so too is paying deductible losses and excess losses from the balance sheet year after year. Over time, a captive will eliminate the need to take cash out of operations for natural disaster losses and assist with smoothing the total cost of risk for an organization.

Is a captive-centric solution the right solution? To be sure, an organization should take a fresh look at its geographic footprint, perform modeling, study its analytics, and determine appropriate limits and retention. Brokers and other qualified captive advisers should be consulted about available limits and structure. Then, an organization should reexamine how its insurance program is structured by comparing it to restructured options that include a new captive arrangement. Captive insurance offers the potential for creativity, flexibility, and a predictable impact on an organization's bottom line. ■