ALTERNATIVE RISK FINANCING DEVELOPMENTS

Paul Woehrmann and Pieter Nyssen of Zurich provides an update to recent market developments for captives and risk managers in the Benelux countries

Three years ago, Dirk de Nil, CEO of Zurich Benelux, and I, Paul Woehrmann, head of captive services EMEA, APAC and Latam at Zurich Insurance Group, provided a strategic review of the Benelux captive market in this publication.[1] At that time a more active use of captives owned by Benelux companies was anticipated. As an example, the so-called holistic view of bringing together two worlds (Life & Non-Life) in one reinsurance captive was discussed.

At the time, we stated that captive owners mostly considered four large lines of business to be included in their captive: for non-life property, liability and marine and for life the employee benefits exposure.

In addition, back then Alexander Mahnke, the chairman of the German Insurance Buyers Association ('Gesamtverband der versicherungsnehmenden Wirtschaft' [GVNW]), reported his observation from the German market that large German captive owners tend to increase their captive retention.

Around five years ago, captive reinsurance was under pressure in Europe following the Solvency II implementation and the regulatory framework of the OECD on Base Erosion and Profit Shifting (Beps). This resulted in captive closures, run-off scenarios and increased novation activities, which also happened in the Benelux countries.

However, over the last three years, we observed a significant change in favour around captive reinsurance. The commercial insurance market shifted from a soft market environment, where capacity was readily available at comparably low prices, to a hardening market where capacity became scarcer, more expensive and more restricted related to terms and conditions.

This hardening of the commercial insurance market made companies evaluate alternative risk transfer solutions. Very recently, Alexander Mahnke stated again that in response to insurers' actions in the hardening market, two-thirds of the members of the GVNW are now looking at alternative risk solutions such as the use of captives, parametric triggers or even capital market solutions.[2]

Also, the Swiss Re Institute published in April economical insights on how captives thrive in tough times.[3] It was highlighted that:

- Companies' use of captive insurance is growing due to rate increases and Covid-19 disruption to commercial insurance.
- A captive can make complex risks more insurable, especially in periods of high uncertainty.
- The use of captives is spreading from advanced markets to Asia and Latin America.
- In advanced markets, mid-sized companies are increasingly using new captive business models that provide flexibility and efficiency.

In the Benelux market, this trend was already visible by the end of 2019, whereby the use of a captive as an effective tool to face the impact of the hardening market received most of the attention (parametric triggers and capital market solutions to a far lesser extent).

The success of a captive being used to mitigate these new market circumstances largely depends on the appetite of a company to take on these risks. Some companies embrace the captive as a tool to soften the impact of the hardening market. Oth-

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ers still hold on to a traditional insurance market approach and reluctantly assume the increased premium rates and/or higher retentions.

At Zurich Benelux, we noted during 2020 a 20% increase in number of captive programmes solely stemming from customers moving from a traditional risk transfer approach to an alternative risk transfer solution via a captive or a Protected Cell Captive (PCC). Again, during the recent 2021 renewal cycle, another 20% of our captive customers increased their captive participation significantly.

In the Benelux, we also observed sizeable increases in captive retentions, particularly in Property. Pushed by higher premiums, reduced capacity and higher deductibles, companies took advantage of their captives through applying higher captive limits and/or through participating on quota-share basis in excess layers (above the traditional primary captive layer).

The benefits of this increased captive retention are not limited only to the layers in which the captive participates, as witnessed by Gerhard Schnellenberg, director of corporate insurance management at ABN AMRO.

"At ABN AMRO, we were faced with an insurer who was prepared to complete the placement on the first excess but only on a bi-par basis at an extremely high premium. By deploying the captive instead of that insurer, we achieved 3 benefits: i) the first excess was placed at 100% making it easier to complete the subsequent layers, ii) the price of the first excess reduced significantly, and iii) the lower price on the first excess generated a positive effect on the higher layers as well. We estimate the total savings in premium (including insurance premium tax) at nearly €1m."

Unlike on the property side, we observed less appetite on the general liability side to cede new or increased liability exposures into the captive. This may be due to the hardening of the general liability insurance market in the Benelux occurring later than in the property market. Potentially, the generally long(er)-tail nature of liability risks has restrained companies from ceding more of those liability risks into their captive.

The Directors and Officers (D&O) liability market was also impacted by the hardening market with premium rates rising and capacity decreasing. As a result, more and more requests were seen in the market to use a captive reinsurance arrangement also for D&O.

Another key challenge for companies is around cyber and protecting critical data and digital assets. This challenge is twofold. On one side, the frequency and costs of cybersecurity breaches continue to grow. On the other side, the cyber capacity in the traditional insurance market is shrinking and premium rates are going up.

The involvement of captives to manage cyber exposure was already outlined in one of our former captive publications.[4] One of the conclusions in the article was that many of the challenges in cyber insurance and global programmes can be managed by pooling the risks in a captive at a reinsurance level. This conclusion is in the current market environment even truer than it was in 2019.

> "Captive owners can also apply this risk prevention approach in order to increase the risk quality of their employee benefits programmes since new risk prevention methods are more or less ready for implementation"

Although captive involvement (in addition to the risk transfer capacity) is a key component to manage cyber risks efficiently, it alone does not provide a complete solution because the pace of change in the cyber segment is much greater than in any other business sector. It is strongly driven by advances in technology and increasing adoption of these advances. For that reason, Zurich has developed Zurich Cyber Security Services jointly with CYE.[5] It helps companies to design and execute effective cyber risk management programmes by giving customers access to unique cyber risk-related expertise and technologies.[6] It also gives more comfort to captive owners to cede cyber risks into their captive.

All captive owners are very keen to run a profitable business under underwriting considerations. They therefore constantly try to reduce the cost of risk and protect profitability by introducing appropriate risk control measures, which reduce the frequency of claims and the cost of premiums. Andrew Bradley, Captive Board Member and former Group head of Risk Services at Nestlé comments on the importance of risk prevention as follows:

"We should always remember that insurance has never prevented a loss and the focus should always be to implement appropriate loss prevention/risk mitigation measures – 'prevention is always better than cure,' and this is even more important if you have a substantial retention in your captive as it's 'your own money' and business you are protecting.

In my view, a loss prevention strategy should be developed and implemented by convincing your colleagues in other parts of your organisation that can help implement, develop and maintain a successful strategy over the long term. Continuous improvement, communication and conviction are the key."

Therefore, it makes sense that companies are currently focusing more on risk prevention and dealing more effectively with the aftermath of loss events, rather than relying solely on insurance protection across the international markets.[7]

Hanno Mijer, global head of Zurich Resilience Solutions is convinced that risks will further change and evolve at a faster pace than ever and companies are facing ever-greater threats, driven particularly by the coronavirus pandemic. He emphasises three main areas of concern: supply chain, cyber and climate change. "What is required is a holistic, end-to-end approach to risk: identifying and evaluating risks, taking proactive measures to prevent and mitigate and practicing your capacity to recover in the aftermath of an adverse event, which is one element of building resilience." [8]

The benefits for a captive owner to engage its reinsurance captive to manage supply chain risk in a joint collaboration with the Fronter and with a highly specialised Risk Insight Provider (here: Risk Methods[9]) can be summarised as in the table overleaf [10].

Captive owners can also apply this risk prevention approach in order to increase the risk quality of their employee benefits

riskmethods benefits for Risk Management/Captives and Procurement

RISK MANAGEMENT / CAPTIVES Benefits:

1. Manage Contingent Business Interruption (CBI) / Time Element (CTE) **capacity** proactively less dependent of insurance market cycle
   - **Provide CBI capacity** through captive according their own needs
   - **Insure un-named suppliers** as well as higher tier suppliers within their captive
   - **Reduce volatility** of CBI capacity and CBI rates
   - Reduce number of CBI claims
2. Drive **profitability** of captive with support of riskmethods tool
   - Can **finance riskmethods tool** and ZRS Services through captive
   - Reinvest captive's CBI underwriting profit to fund CBI risk improvement
   - -> gain importance & visibility within procurement, Supply Chain Management & CFO
3. **Access re-insurance capacity** easier based on riskmethods information on SC Risk and **arbitrage (wording, capacity, price)**
4. **Use captive to access to broader re-insurance market capacity**
5. **Availability of high-quality CBI data** to enhance capacity for CBI capacity providers

PROCUREMENT Benefits :

1. **Change in Supply Chain Management organization towards alignment and resilience**
2. **Less fire fighting and associated high costs, therefore, lower total cost of supply**
3. Early warning as competitive advantage in securing restricted supplier volume for own needs
4. Visibility in the Supply Chain
5. Identify critical suppliers and therefore, ability to manage and reduce associated risk
6. Efficiency in managing risks in the supply chain for procurement

Joint Risk Management & Procurement Benefits – i.e., **organizational benefits**

- **Alignment through early warnings in Supply Chain Risk information**
- **Alignment in change of Supply Chain Management**

programmes, since new risk prevention methods are more or less ready for implementation. Michael Bischof, COO of LiveWell, states: [11]

"Health and wellbeing are key preconditions for an employee's success. At LiveWell, we offer personalised digital services focusing on four essential pillars of health – physical, mental, social and financial. There is clear evidence that digital health services improve employee engagement, retention and productivity. For captives, this offers new opportunities to prevent and manage employee related risks."

Risk managers who have no access to a reinsurance captive are less flexible to respond to market changes and might have more challenges to manage their core buying and selling processes in insurance terms compared to captive owners. Since they cannot approach the reinsurance market for risk transfer purposes, they are only able to compare market choices provided by the insurance market. Therefore, we have observed that many of these midsize companies are seeking advice on how to obtain similar benefits by using PCC's.

Tellingly, the publication of the world captive domicile update in March 2021 showed an increase in the number of PCCs. [12]

In line with this, we also witnessed in the Benelux an increased interest by large and upper mid-market corporates to evaluate PCC solutions. This interest resulted, particularly in the Dutch market, in customers opting to obtaining a cell in a PCC.

Alongside this increased interest at corporate level, we experienced the same interest and eagerness to learn more about captive and PCC solutions from the large national brokers. Similar to the global brokers, large national brokers also want to offer these captive or PCC solutions to their larger customers, in close collaboration with fronting carriers and/or captive management providers.

Summary

Captive involvements are an important market factor within the international commercial insurance world and have become even more important during these challenging times. Such tailor-made tools can enable captive owners to make complex risks more insurable. In addition, top middle market risk managers would like to get access to alternative risk financing solutions. Very much in scope are currently in this regard the PCCs.

These developments also apply to the Benelux market.

For captive owners, it is key to be able to rely on a globally experienced fronter with a strong network also to limit the administrative costs.

Zurich is flexible to enable access to strategic and customized decision options with its global experience on captive related topics in order to meet the expectations of the Benelux risk management community.

[1] Paul Wöhrmann; Dirk de Nil: Strategic review of Benelux captive market, in: Captive Review, April 2018, p. 26-28

[2] Versicherungsnehmende Wirtschaft prüft Alternativen zur klassischen Industrieversicherung, in: Versicherungswirtschaft Heute, March 26, 2021

[3] Swiss Re Institute-sigma research: Economical insights hard market solutions: Captive Insurance thrives in tough times, issue 7, April 8, 2021

[4] Paul Wöhrmann; Lori Bailey: Cyber-Security and risk control, in: Captive Review, June 2019, p. 36-37

[5] For further information please see: www.zurich.com/products-and-services/protect-your-business/what-we-protect/zurich-cyber-security-services

[6] For more information: http://www.zurich.com/products-and-services/protect-your-business/what-we-protect/zurich-cyber-security-services

[7] The Need For Resilience In The Face Of Uninsurable Risks, in: Commercial Risk Europe, 26/03/2021

[8] The Need For Resilience In The Face Of Uninsurable Risks, in: Commercial Risk Europe, 26/03/2021

[9] Risk Methods definition: https://www.riskmethods.net/

[10] Dr. Otto Kocsis, Zurich Resilience Solution internal paper, Zurich, March 2021

[11] Zurich Livewell is Zurich Insurance Group's health and wellbeing start-up, https://livewell.zurich.com/

[12] Lauren Ingram: World domicile update, in: Captive Review, March 2021, p.3; Versicherungsnehmende Wirtschaft prüft Alternativen zur klassischen Industrieversicherung, in: 'Versicherungswirtschaft Heute/online, March 26, 2021