Captive Fronting: Sixty Years and Still Going Strong

Nuno Antunes of AIG Global Risk Solutions explains why the captive fronting market is as dynamic as ever.

Captives have been around for more than 60 years. Today, more than 6000 captives operate in more than 50 domiciles. We are also currently experiencing a prolonged competitive insurance market and a more challenging regulatory environment. With that as a background, one might think that captive fronting is a mature, staid marketplace with not much happening. In fact, nothing could be further from the truth.

Today, we are seeing a dynamic fronting marketplace with increased activity being driven by:

- Multinational expansion;
- Captives participating in a broader range of traditional insurance coverages, for example, trade credit and employee benefits;
- The emergence of new risks that may not be covered by traditional insurance markets, for example, non-damage business interruption, cyber risk, and pandemic coverages; and
- Increased interest in alternative structures that offer similar benefits to owning a captive at a lower cost.

From emerging markets in Latin America and Asia to the more well established markets in the US and Europe, risk management continues to become more entrenched in corporate cultures. Senior management increasingly look to their risk managers to play an important role in the company’s business strategy and to protect the company from the various risks it faces. Many of those risk managers tell us that their use of captives will continue to grow.

This is supported by a recent multinational survey conducted by the Federation of European Risk Management Association (FERMA), which found that 30 percent of respondents were considering implementing a captive program or expanding the use of an existing one.

So now, let’s take a look at what we see as four key drivers of the increased activity in captive fronting.

Multinational expansion

There is no question that we are living in a globalized world that will continue to become more integrated regardless of the challenges involved.

The globalization trend is evidenced in almost everything we read today. Consider the fact that by 2025, emerging markets are expected to have about half of the largest corporations in the world.

In a recent study AIG conducted in the UK, more than 20 percent of respondents said that they would be expanding internationally in the next two years.

Similarly, the Institute of Export surveyed UK businesses and found that 69 percent of respondents thought their dependence on exports would increase in the next five years.

Rising living standards generating consumer demand combined with emerging technologies expose companies to global markets and consequently, to different regulatory environments at a time when doing business abroad is more challenging than ever.

As a result, companies today realize early on that improvising around local solutions and policies has become too time consuming, complicated and costly and may expose them to regulatory, tax or legal problems.

This is, we believe, one of the factors that explain the growing interest in multinational programs in general and more particularly, in multinational captive fronting programs.

Not without its challenges in terms of the quest for the four Cs (consistency, contract certainty, claims handling and compliance), multinational programs are, and will very likely continue, being an integral part of the agenda of most captive owners.

Less traditional (in terms of captive usage) lines of coverage

Until recently, only a few and usually very large, sophisticated clients would consider using their captive for anything other than their traditional

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property and casualty lines. Today, we see an increasing number of clients retaining risks such as liability, trade credit, environmental liability, product recall and employee benefits (specifically benefits solutions and medical stop loss coverage in the US, in the wake of the Affordable Care Act). This presents challenges and opportunities, but one thing is unquestionable; adding these new lines helps companies to have greater diversity and stability in their overall captive programs. Risk diversification is important, especially for companies facing Solvency II on the horizon.

Expanding a captive program with additional lines of business can also strengthen the financial benefits that the captive provides to its parent as premium levels usually increase significantly and exposure to loss is diversified.

**Risks falling outside the appetite of the traditional insurance market**

As risk managers’ profiles continue to rise within their own organizations, we also see captives taking on a more important role in their companies’ business strategies. Often tasked with driving a risk management culture throughout the organization, risk managers are now being asked to provide risk retention solutions when the traditional insurance markets cannot provide the coverage, capacity or efficient pricing that senior management views as necessary to achieving its strategic objectives.

Events such as the volcanic ash cloud, the Fukushima disaster or the floods that every year occur in many parts of the world have disrupted business through their impact on the circulation of people and goods.

With non-damage business interruption firmly on their radar, some captives have been working with us to create fronted programs that would enable them to retain the risk in a more formalized and structured way, so that they can appropriately fund for that coverage and allocate the cost among their various business operations.

Cyber and pandemic risk are two more examples of new risks that clients are retaining via their captives.

Let’s start with the rationale for retaining cyber liabilities.

Traditional cyber risk transfer programs are becoming very popular, but there is still uncertainty around all of the types of exposures that might result from a cyber breach and some perils may not be covered.

So, programs where the captive not only retains the primary layer or deductible of a traditional cyber liability policy, but also expands the coverage provided, are coming to us on an ever more reoccurring basis.

As regulators and rating agencies are now routinely publicly discussing cyber risk exposures, we expect to see more of these programs in the future.

Recent news coverage highlights the potential effect of a pandemic spread. The 2014 outbreak of Ebola seems the most serious since the virus was first identified nearly four decades ago. We expect to see captives continuing to play an important role in the way pandemic risk is financed in the future.

The fast track captive program: ‘rent-a-captive’/cell captives

As mentioned before, risk management is becoming more strategically integrated with the company’s business objectives, and companies are considering risk financing/retention at an earlier point in their lifecycles than in the past. But at this stage, small- to medium-sized companies may not be ready to commit the capital and resources needed to form and manage their own captive. For these companies, a ‘rent-a-captive’ or captive cell is usually the easiest solution.

We continue to see important growth in cell captives around the world. Bermuda created this concept more than two decades ago. Other jurisdictions have implemented similar structures such as the sponsored captive insurance company in Vermont and other parts of the US, protected cell companies in Guernsey, and series limited liability companies in Delaware and other US domiciles.

In very simple terms, the owners of these cell facilities are allowed to create multiple cells and then ‘rent’ them out to participants.

By paying a ‘fee’, participants gain access to a portion of a cell facility owner’s capital, surplus, licenses and administrative services and can use those to insure or reinsure a portion of their risks.

Participants may be required to post collateral to satisfy the credit requirements of the front and/or cell facility.

These cell programs can be formed quickly with minimal start-up costs and are available for virtually any line of business. The assets and liabilities of each cell are legally segregated. A cell program can be easily converted to a standalone captive if a company later decides to form its own captive.

Closing

The captive fronting market is a dynamic market place. We expect that trend to continue and in fact, accelerate in the future. Companies are using captive programs to meet a wide variety of today’s needs, and in the future, new needs will emerge.
Tailoring the design and administration of a program to effectively meet those needs can be challenging, and for that reason, the choice of the right insurance partner is one of the keys for success.

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