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Economic insights

Hard market solutions: captive insurance thrives in tough times

Key takeaways

- 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.
- 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.

About Economic insights
Analysis of key economic developments and their implications for the global re/insurance industry.

Managing Editor
Jérôme Haegeli
Swiss Re Group Chief Economist

Authors
Thomas Holzheu
Chief Economist Americas

Irina Fan
Head Insurance Market Analysis

We welcome your feedback. For any comments or questions, please contact: institute@swissre.com

In a nutshell

Companies are increasingly using captive insurance to self-insure their risks, as rate hardening and COVID-19 disruption affect commercial insurance. Captive use is expanding to Asia and Latin America, and to mid-sized companies, for which new business models for captives open up options to self-insure more flexibly and efficiently.

Disruption and uncertainty in global commercial insurance markets is prompting companies to explore captive insurance, defined as wholly owned self insurance, rather than buy from third parties. Commercial insurance markets are experiencing rate increases, capacity reductions and tighter underwriter scrutiny as the market reacts to COVID-19-related losses, social inflation, above-average catastrophe losses and secular downward pressure on investment returns.[1] Exacerbated by uncertainty created by the pandemic, the current rate hardening is the strongest in 20 years and we expect this to continue into 2022 (see Figure 1). Many commercial insurance programmes are increasing deductibles, retentions and coinsurance as ways to curb insurance spending. The pressure is leading companies to increase their utilisation of existing captive insurers and form new captives. A Marsh survey in September 2020 found 59% of respondents expected to expand their captive use by adding more lines of coverage, increasing retentions in the captive.[2]

Captive insurance enables a corporation with large portfolios of risks to better bundle and diversify them, and to access global insurance and reinsurance markets directly. By self-insuring high-frequency, low-severity risks through a captive, a corporate can reduce transaction costs (brokerage fees, underwriting expenses) and focus risk transfer on lower-frequency, higher-severity risks for more efficient risk management. Captives benefit from better access to data and closer proximity to the risks of their sponsors, so can more flexibly develop customised products that cover the changing needs of their corporate parent. This becomes increasingly important with the emergence of new risks and uncertainties regarding how to determine the frequency and severity of those risks. Advanced data analytics and actuarial developments support captives to underwrite hard-to-insure risks such as cyber.[3]

There are now more captive insurance companies than traditional insurers globally, estimated at more than 7000 captives domiciled in more than 70 jurisdictions.[4] The US is the world's leading market for captive insurance, used by up to 70% of Fortune 500 companies.[5] With high saturation among large corporations in North America and Europe, the use of captives is spreading geographically to Asia and Latin America. Globally, 46% of companies are likely to explore a new captive,

[1] "Europe's Captive Segment Poised for Growth Amid Hardening Insurance Conditions", *AM Best*, 30 November 2020.
[2] *Captives Offer Value in Uncertain Times*, Marsh, September 2020.
[3] " Global Risk Management Survey 2019", Aon.
[4] "Rated Bermuda, Cayman Islands, and Barbados Captives Continue to Outperform Peers", *AM Best*, 17 December 2020.
[5] "Asia, LatAm and the Middle East ripe for captive growth: CICA board chair", *Captive International*, 9 March 2020.

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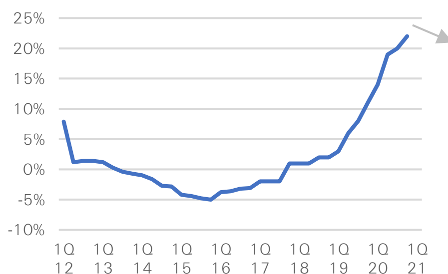
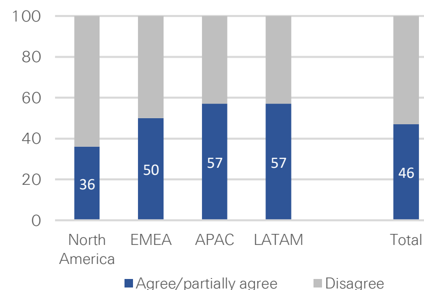
according to a recent survey by Aon. In Asia Pacific and Latin America, where use of captives is lower, that share is higher with 57% of respondents (see Figure 2).

Figure 1. Global commercial rates



Source: Marsh

Figure 2. Explore forming a new captive (%)



Source: Aon COVID-19 risk management insurance survey, February 2021

Captive use is also expanding from the traditional large global corporations to mid-sized companies. This is in line with the growth of alternative structures and business models for captive insurers, which fit the needs of a wider spectrum of organisations (see Table 1). Structures such as Protected cell companies (PCC) and virtual captives enable smaller corporates to access the benefits of captive insurance without needing to set up the infrastructure themselves. We expect to see continuing momentum in the global market for captive insurance as companies seek a more flexible and efficient insurance solution amidst uncertainty and a hard market.

Table 1: Alternative captive structures

Rental captives	A rental captive is a captive insurance company that can be used or "rented" by unrelated insureds. It allows insureds to gain the benefits of a captive insurance arrangement without participating in the captive insurance company's ownership or management. The sponsor charges fees for the use of their statutory capital and for operating the captive.
Protected cell companies	PCCs are essentially rental captives with a special provision that legally separate the assets and liabilities in each insured's account or "cell" from those of every other participant's "cell." The structure is essentially the same as that for a rental captive with no risk sharing, but PCCs have the additional benefit of statutory protection. These solutions are only available in specific (mostly offshore) regulatory regimes.
Virtual captives	A virtual captive is a multi-year agreement with a licensed insurance company, replicating the financial mechanics of a traditional captive without setting up a regulated special purpose insurer.[6] Most risk will be self-financed over time by the customer, the remaining peak risk is transferred to the insurer. The insurer, in turn, collects a risk premium and a fee to cover the cost of providing the balance sheet and running the program. Virtual captives remove the dependence on fronting and collateral arrangements.

[6] See for example http://corporatesolutions.swissre.com/innovative-risk-solutions/captive-solutions/virtual-captive-solutions.html.

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