# How tall is your tower?

Frances Jones investigates how captive owners can engage with reinsurance markets and why they should also be a consideration for captives

Reinsurance markets can benefit captives by giving them access to higher towers.

"Moving up higher reinsurance towers allows captives access to more reinsurance carriers and potentially better terms," asserts Grainne Richmond, an executive vice president and head of captives at Aon Bermuda.

"This ultimately better protects the policyholder. It also gives the captive access to additional knowledge and experience from different areas. For example, we're seeing increased access to cyber, in particular. Parent companies obviously have very experienced risk managers, but for niche areas, such as cyber, they will not have that subject-specific knowledge. Their captive will be able to access that through reinsurance markets."

A 2021 segment report from AM Best, entitled 'US cyber: the hardest of the property and casualty markets', finds that captives are using third-party technology and forensic cyber consultants to help with underwriting cyber. This is in addition to the regular monitoring of parent's cyber security policies, procedures and testing. Cyber risk modelling improves as more data becomes available. Therefore, captives that engage with reinsurance carriers — with a wealth of existing cyber data and experience — should be able to provide improved cyber services to a parent. This could also be more cost-effective for the parent, as they will forgo the cost of engaging with third-party cyber consultants.

The cyber market continues to grow. In the executive summary of its 'Cyber Summit', Lloyd's of London predicts that the cyber market is going to treble in size from £13 billion (US$16.8 billion) in 2022 to £35 billion ($45.3 billion) in 2030. Subsequently, the need for cyber coverage is projected to exponentially increase to fill coverage gaps left by the traditional market. Cyber modelling capabilities of reinsurance carriers and opportunities for captives are also expected to increase.

## A long-term and a short-term solution

Rick Hartmann, a senior vice president within the captive segment of Guy Carpenter, says: "Captives and risk managers should consider engaging the third-party reinsurance market to allow access to additional capital and to potentially identify more efficient risk transfer solutions. Prospective treaty and facultative reinsurance solutions can help captives manage volatility and protect their balance sheets."

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>
> **Rick Hartmann, Guy Carpenter**

Treaty reinsurance is insurance purchased by an insurer from another company. It is utilised when an insurance company wants to share the risk of a certain group of policies, called a book. For example, all policies for marine insurance that are held by the insurance company will be in its marine book and it may choose to reinsure its associated risk. It indicates that the companies involved will engage in a longer-term relationship.

Demian Smith, head of mutual, agency and captive reinsurance solutions for global marine and energy at Guy Carpenter, says: “A treaty-style reinsurance approach will not suit all captives. There is a certain level of scale and technical capital management know-how that will be required to achieve the pricing and administrative simplicity benefits that can be achieved.”

He adds: “This is in comparison to traditional captive reinsurance predicated on specific risk protections. The end result is always very bespoke and requires active management of the captive in the day-to-day risk-taking activities of the captive.”

On the other side of the coin, facultative reinsurance typically considers each policy individually and signifies that the companies will work together in the short-term.

Hartmann comments: “Guy Carpenter’s captive segment actively places treaty reinsurance on behalf of more than two-dozen group captives, and we have executed more than 65 transactions with single parent captives.”

Considering the macroenvironment, he adds: “In the face of rising commercial insurance costs, risk managers and captive owners are looking to increase the utilisation of their captives to both finance and transfer risk more efficiently. As a result, we have executed structured reinsurance solutions for several large and publicly-traded companies.”

Hartmann lists the range of solutions the reinsurance market can offer a captive. He includes employee benefits, medical stop-loss, parametric, structured risk and insurance-linked securities which provide a blend of risk financing and risk transfer.

## Don’t just buy one

It almost goes without saying that captives can only access higher towers through purchasing multiple lines. Richmond says: “It really boils down to diversity, you want multiple lines to diversify your captive. We always recommend that our clients don’t just go with one line in their captive, that feeds into the reinsurance carriers as well.”

Hartmann adds: “For casualty group captives, writing multiple lines of business affords the opportunity to add balance to a potential reinsurance solution where one line may be underperforming or more challenged compared with others.”

When captives gain access to additional reinsurance carrier’s, they can also use its data and analytic modelling tools. Willis Tower Watson’s report ‘Insurance Marketplace Realities 2023 Spring Update — Captives’, says that data and analytic capabilities are “key enablers of change”.

Access to these advanced analytics tools, via reinsurance carriers, could enable captives to cover emerging risks, including those associated with the climate crisis. “Captives are starting to delve into climate, leveraging the knowledge of reinsurance carriers and their existing climate assessment capabilities,” says Richmond.

The report also finds that, in US domiciles, the diversification of a captive’s portfolio continues to drive innovation. Therefore, captives looking to increase their sophistication and innovation should consider diversifying their offering by purchasing multiple lines from reinsurance carriers.

Smith gives his thoughts: "In particular, diversification can lead to better risk assessment and pricing in addition to smoother returns. This is due to more stable and predictable outcomes across the portfolio and overall risk reduction through the diversified nature of the portfolio."

"Having diversity in your captive gives you that control. It also makes reinsurance carriers aware of the stability a captive can bring."

## Amid challenging market conditions

A 2023 AM Best market segment report, 'Global Reinsurers Face Challenges Even as Conditions Improve', finds exactly what its title outlines: "Despite challenging conditions, the global reinsurance segment still returned an underwriting profit in 2022."

The report notes concerns about economic and social inflation, central banks' contractionary monetary policies, asset market volatility and the recent underperformance of the global reinsurance segment, have all underpinned a higher cost of capital.

It highlights its stable outlook of the market is due to reinsurers' prudent approach to deploy capital, balanced with market participants' pressure to innovate and expand.

Richmond comments: "Amid hard market conditions, it has been good to see players in the reinsurance market working with our clients and with the brokers to provide the coverage where that is possible."

Against this backdrop, Hartmann considers the incentives for captives to purchase extra reinsurance coverage. He says: "Captives, similar to traditional property insurers, have faced a confluence of macroeconomic factors, which has led to an increase in demand for reinsurance. These factors range from continued core and social inflation to elevated levels of global catastrophe losses. We believe demand for reinsurance will grow with reinsurers' willingness to deploy capital."

The WTW report highlights that property markets remain challenging which is reflected in the increased use of captives as vehicles to assume greater levels of risk retention.

Hartmann stresses that reinsurance coverage and risk transfer solutions should be set in accordance with its risk tolerances and aligned with the captive's enterprise risk management framework. He notes: "Captives should look to avoid situations where rating agencies, such as AM Best or Fitch, may perceive its operating performance as over-reliant on reinsurance."

Captives can also be used to incubate multiple risks against hard market conditions. Smith writes that, "in addition to excess of loss reinsurance protections, diversified captives can approach the structured reinsurance markets to identify stop-loss and risk finance programme reinsurance solutions to protect the captive from attritional volatility."

## Commit to a long-term relationship

Hartmann says: "In the face of macroeconomic or market headwinds, and decisions on where to allocate capital, reinsurers will differentiate between those partners with whom they have established trusted relationships and those looking to start a relationship."

Aon has long-standing relationships with provider-owned, specialty and commercial medical professional liability (MPL) insurers within the medical malpractice (med mal) space. It serves 20 MPL ceded companies and places more than US$225 million of reinsurance premium with 30 reinsurers in the US, London, Bermuda and Europe.

Richmond comments: "Captives can create long-term reinsurance relationships through their brokers, such as Aon and their captive manager. By jumping from reinsurance carriers on a year-on-year basis, you're losing a lot of the understanding and knowledge that has built up in the personnel you're dealing with. As we saw in the last few years of the hard market, those who did not have those relationships experienced tight capacity with those reinsurance carriers."

Richmond, providing an example, says: "We have seen an uptick in towers being purchased in the med mal space. Renewals in the healthcare space have been difficult for brokers and underlying insureds for the last few years. We did see some players in the reinsurance market stepping away from med mal coverages."

She concludes: "However, for Aon's clients in that space — where towers were in place through the captive — the relationship was the key for renewals. Aon is a professional service firm, which is paramount. We cannot lose that touch with our clients." ■