MARSH

THE CAPTIVE LANDSCAPE | SEPTEMBER 2020

Captives Offer Value in Uncertain Times

Effective tools to address pandemic and other risks

MARSH & McLENNAN COMPANIES

CONTENTS

INTRODUCTION

Maps from antiquity referred to uncharted territories as "terra incognita," showing sketchy outlines of lands not yet known. Organizations today face their own terra incognita as they strive to navigate complex global risks. Many are using their captive insurance companies to help pilot them through the COVID-19 pandemic, a challenging insurance market, and other risks.

Captives have stood the test of time as effective tools to navigate through uncertainty. As the 13th annual edition of Marsh's *Captive Landscape* shows, premium growth in captive insurers continues to accelerate, a sign of their strength in protecting people and infrastructure. This growth signals that owners recognize captives' advantages, which include cost efficiencies and flexibility in protecting financial and human capital.

The ability to design customized insurance coverages, access alternative capital, and generate profits through third-party business makes captives especially valuable during market transitions. The global insurance market may continue to tighten as the pandemic's impact becomes clear. Captives can help organizations become more agile in responding to risks and protecting their people and assets.

In addition, domiciles around the world are embracing changes in captive regulations to encourage innovation. A Marsh survey of captive regulators shows domiciles are seeing captives adopt sophisticated technologies and write more third-party risks.

As the world's leading provider of captive management and consulting services, Marsh is proud to present the *2020 Captive Landscape* report. Our client service team stands ready to assist you in navigating complex risks through changing times.

Ellen

Ellen Charnley, President
Marsh Captive Solutions

Captives and Pandemic Risks

Most organizations will remember 2020 as one of their most demanding years. In addition to the pandemic and resulting worldwide business disruption, the global insurance market is experiencing a number of challenges following years of claims inflation and emerging risks — including, but not limited to, COVID-19.

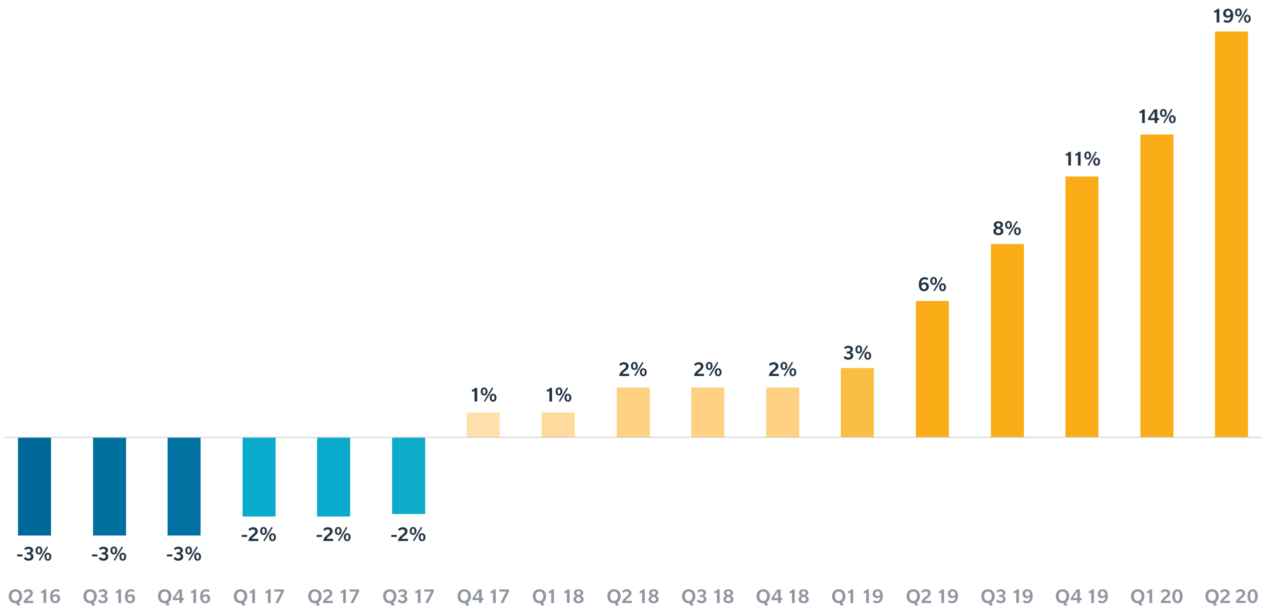
In the second quarter of 2020, commercial insurance rates globally rose by an average of 19%, according to the *Marsh Global Insurance Market Index* — the largest increase since the index's inception in 2012 (see Figure 1). Looking ahead, the insurance market tightening that began in some lines in 2018 could accelerate, potentially leading to even less capacity. Where the road leads is unclear. To navigate these market conditions, however, many organizations are turning to captives.

COVID-19 has spread globally since late 2019, when the outbreak started in Wuhan, China. By late August 2020, the coronavirus had infected more than 23.5 million people and claimed more than 810,000 lives, with cases reported in 216 countries, territories, or areas, according to the World Health Organization (WHO).

FIGURE 1

Global insurance prices, on average, have risen every quarter since the fourth quarter of 2017.

SOURCE: MARSH ANALYTICS SOLUTIONS



Starting in late January, as many governments ordered lockdowns to contain or slow the virus's spread, the impacts have included:

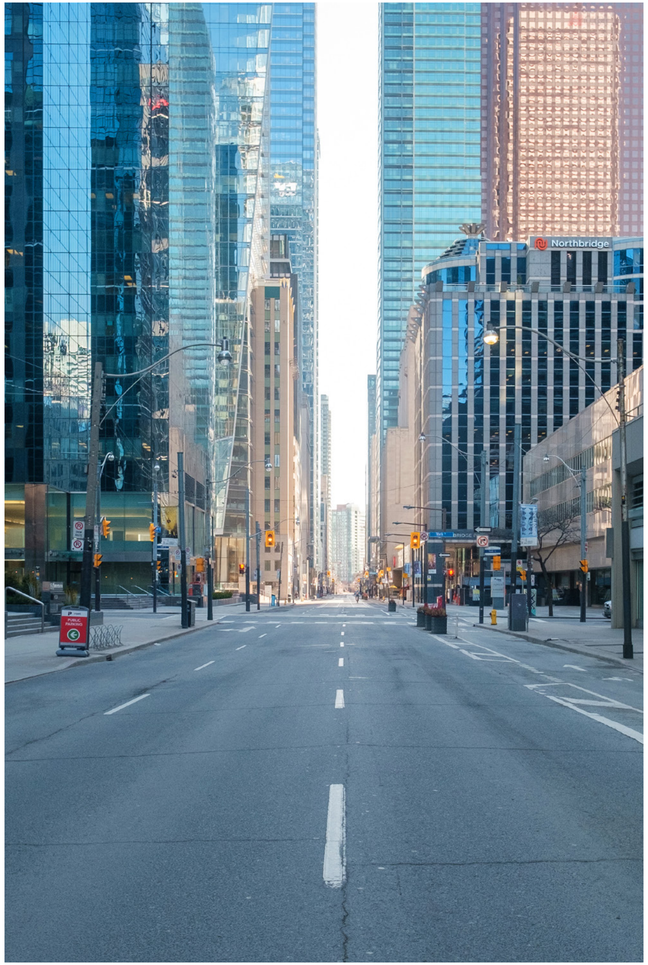
- Closing nonessential businesses, or prohibiting them from serving customers on premises.
- Laying off, furloughing, or giving salary cuts to millions of workers.
- Instructing large portions — in some cases, all — of employees to work remotely at many companies.
- Disrupting global supply chains.
- Canceling or postponing thousands of events, including entire seasons for some professional and college-level sports.
- Stranding travelers on cruise ships, which many countries barred from entering ports until passengers and crew were tested for the coronavirus.
- Converting some manufacturers' production lines to meet demand for ventilators and surgical masks for health care professionals and hospitals treating COVID-19 patients.
- Racing by pharmaceutical and life sciences companies to develop tests and vaccines.
- Emptying of public spaces as people hunkered indoors and largely abandoned city centers.

As governments in some areas began loosening restrictions following initial lockdowns, some saw spikes in COVID-19 cases, sparking concerns about a second wave or resurgent first wave of infections and deaths.

COVID-19's full impact is not yet clear, but a global slowing of economic growth is already underway. In June, the International Monetary Fund (IMF) predicted COVID-19 could cause the global economy to shrink by 4.9% in 2020. By comparison, during the global financial crisis in 2009, global GDP shrank by 1.7%. What is clear: The COVID-19 pandemic has touched virtually every industry.

Commercial insurers are already seeing or expect to see COVID-19-related claims in many lines of business, especially business interruption (BI), contingency/event cancellation, workers' compensation, directors and officers liability, employment practices liability, cyber, surety, travel, political risk, supply chain, and trade credit. As a result, insurers are increasingly adding pandemic exclusions to new and renewal policies.

In the *Pandemic Risk Protection Report 2020*, Marsh suggests that a public-private partnership can provide a long-term solution for pandemics. Among Marsh-managed captives globally, at least 25 are writing coverage for pandemic risks and we expect more will in the future based on interest we have received. A number of industries that contribute significantly to US gross domestic



product already use captives to mitigate financial losses from pandemics (see Figure 2).

Example of captive use during a pandemic

To illustrate how a captive can mitigate financial losses during a pandemic, consider a hospitality company, such as a hotel/restaurant. During the pandemic, the company could lose substantial revenue from the cancellation of existing reservations and event bookings. This could last for several months, or longer. Restaurant operations could continue serving patrons through deliveries and curbside pickup of food orders, but revenues would suffer if customers stayed away.

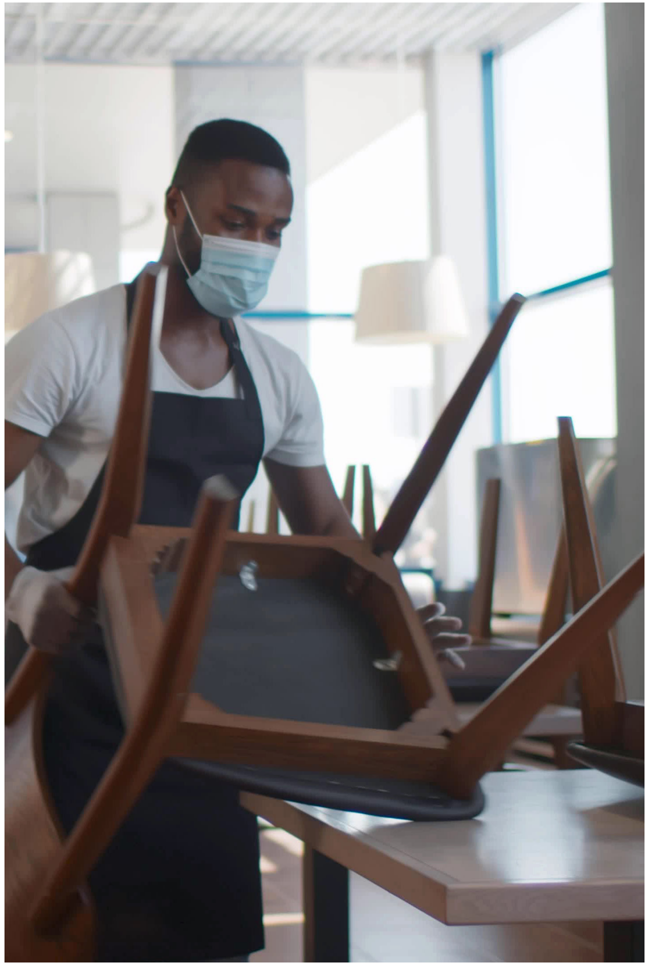
In addition to business interruption, the pandemic may disrupt the hotel/restaurant's supply chains, from linens to personal protective equipment to food and takeout containers. With fewer guests and dining patrons, the company's staff needs are greatly reduced. Many may face furloughs or layoffs, and they may be concerned about maintaining their own health during the pandemic.

FIGURE 2 Industries already using captives to mitigate pandemic-related losses include food, beverage, and hospitality; manufacturing; pharmaceutical and health care; and retail trade.

EFFECTS OF PANDEMIC	HOW A CAPTIVE CAN HELP	HOW A CAPTIVE CAN INCREASE LIQUIDITY
Business interruption (BI)/ contingent business interruption (CBI)	Liquidity/cash flow	Dividends
Supply chain disruptions	Pre-loss risk funding pandemic coverage	Intercompany loans
Loss of customers	Protection of human capital, such as indemnity protection, voluntary employee benefits, and funding for telemedicine, among others	Premium financing through discounts or "holidays" to policyholders
Event cancellations	Supply chain funding support	Actuarial discounting of reserves
Furloughed or laid off workers		Paying for risk control services/ return to work planning
Shifting to online transactions and delivery model		Investment in less liquid assets of parent or affiliates in exchange for cash
Shifting production in response to shortages		
Inventory losses, waste, or surplus		

With a captive, the hotel/restaurant company could mitigate the financial losses arising from the pandemic in a number of ways, including:

- **Pandemic coverage.** Captives can design customized insurance coverages that are not available in the commercial market. Through its captive, the company can write policies that cover pandemic risks tailored to the company's exposures. For example, contingency/event cancellation coverage without pandemic exclusions might be impossible to buy from commercial insurers, but captives can write it.
- **Pre-loss risk funding.** Captives serve as formal mechanisms for pre-loss funding. The hotel/restaurant can tap the captive's funds as coverages are triggered.
- **Protecting human capital.** A captive can fund benefits (such as hospital indemnity) and safety programs, providing valuable protection for employees and their dependents during public health emergencies.
- **Cash flow and access to capital.** Businesses that face government orders to close or that suddenly lose customers may experience severe cash flow issues. Incurring unexpected expenses while trying to maintain payroll can quickly exhaust available cash. A captive can provide relief through pre-loss funds as well as access to alternative capital, including intercompany loans.
- **Liquidity.** Captives also can provide the hotel/restaurant with options to improve liquidity. Surplus and investment income built up in a captive may support the captive owner's need for liquid assets.
- **Supply chain funding support.** During a pandemic, businesses and their suppliers may face similar financial pressures. A captive can write first-party coverages that provide valuable funds to its owner in the event one of its suppliers cannot fulfill its obligations.
- **Cyber risk management.** An enormous number of businesses during the pandemic have asked workers to perform their jobs remotely, where possible. This means many more workers are using the internet and connected devices, increasing their employers' exposure to cyber risks. Captives can write cyber insurance to protect against losses from data breaches and network failures.



IN FOCUS

What's on the Horizon for Public-Private Pandemic Partnerships?

Terrorism risk backstop offers insights for pandemic risk financing

The nature of terrorism and pandemic risks offers private-sector insurers little opportunity for diversification, and the scale of large events can overwhelm private capital. Such risks require government support to keep markets stable, and insurance coverage available.

Various public-private partnerships exist around the world to finance volatile risks. These include Pool Re and Flood Re in the United Kingdom; GAREAT in France; and the Terrorism Risk Insurance Program, National Flood Insurance Program, and California Earthquake Authority in the United States.

Across Europe, discussions are taking place among stakeholders — including risk management associations, insurers, and regulators — about creating state-backed insurance pools to protect businesses from pandemic risk. Additionally, there have been calls for a pan-European resilience framework to address all non-damage business interruption (BI) risk, which the European Commission and local regulators support. This approach is not without complexity, but there is broad acceptance that any solution will require partnership between the public and private sector and a balance between state and private risk capital.

There are several initiatives underway in the UK, supported by the country's risk and insurance management association, Airmic, including a steering group to look into a UK public-private pandemic solution, known as Pandemic Re. This could follow the template set by UK government-backed programs such as Pool Re or Flood Re. In the US, the Pandemic Risk Insurance Act (PRIA), like the Terrorism Risk Insurance Act (TRIA) that inspired it, would create a federally funded reinsurance program intended to support the insurance industry, including captive insurers, from inherently large and unpredictable risks.

Introduced in May by Rep. Carolyn Maloney and co-sponsored by two dozen legislators in the US House of Representatives, H.R. 7011 would create a $750 billion compensation program to pay for BI losses arising from pandemics declared by federal authorities. Participating insurers could tap the government program once industrywide losses exceed $250 million. A deductible of 5% of subject premium per insurer would apply, with PRIA covering 95% of losses above that, up to $750 billion. If enacted, the legislation would take effect in January 2021 and sunset December 31, 2027. Congress was scheduled to hold hearings in late June to discuss PRIA's provisions, but the hearings were delayed. Now, the earliest that the first hearings are likely would be late in the third quarter. Although the PRIA legislation is in its early stages, it is something captive owners and prospective owners will keep sight of.

Unlike TRIA, participation in PRIA under the current proposal would be voluntary. If an insurer were to opt to participate in a given calendar year, then for that calendar year, it must offer

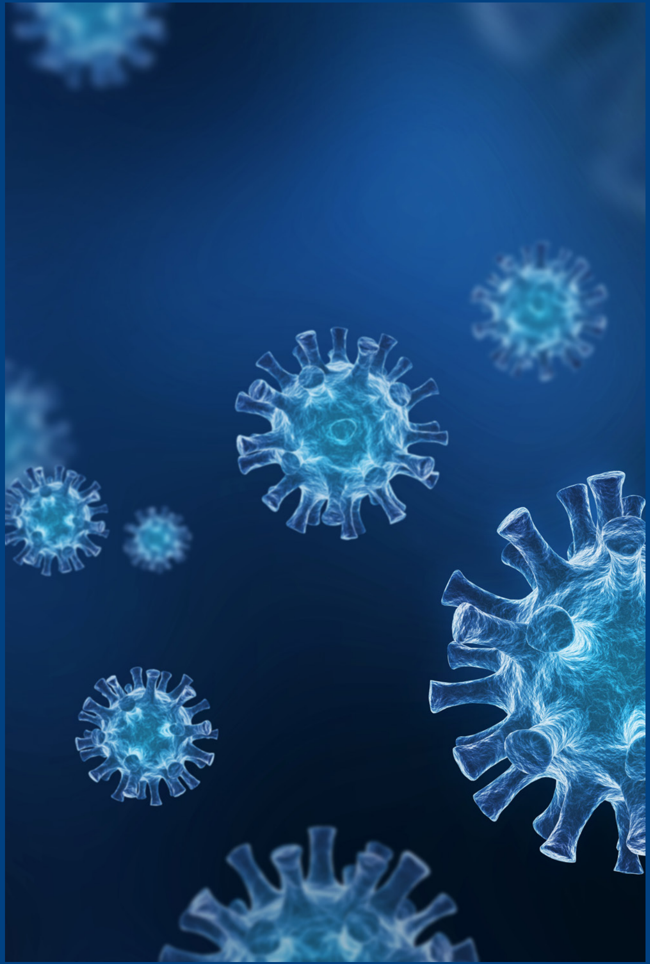
BI coverage that does not differ materially from the terms applicable to BI losses arising from events other than public health emergencies. A significant number of captives offer terrorism coverage that is reinsured under the federal government program. More captives might participate in PRIA because pandemic exposure affects all organizations. PRIA offers multiple potential benefits, including:

- Mitigating catastrophic financial risk arising from future pandemics.
- Providing certainty to businesses and employees disrupted by pandemic events.

PRIA is one of several proposed pandemic risk solutions. A number of our partners in the insurance industry have put forth thoughtful proposals to address pandemic risk, and we look forward to collaborating on a solution that works for all stakeholders. Another solution in development is a parametric product for small and midsize employers that wish to compensate employees for expenses incurred due to extended coronavirus hospitalizations. Not a form of insurance, but rather an indemnification of expenses not covered by medical or other insurance, employers could pre-fund such a program through their captives.

For example, an employer might offer $3,000 in extra-expense compensation to each employee who contracted a covered illness, such as COVID-19, and had a hospital stay of seven or more days. The employer could park in a captive the funds to pay those anticipated expenses, rather than setting aside a balance sheet reserve.

PRIA and the parametric product illustrate different ways that captive owners potentially can find creative solutions to emerging and complex risks.



Improving Liquidity

From risk financing to intercompany lending, captives can reduce liquidity issues

Financial flexibility is one of the key advantages of captives, which is of particular interest now as cash flow has come into sharp focus during the pandemic.

When businesses face supply chain disruption, government orders to close their operations, shift how they can continue to serve customers, and/or ask employees to work remotely, cash on hand can dwindle. During the COVID-19 pandemic, a major impetus for economic stimulus and relief legislation was the financial impact on small and midsize businesses and their employees. Since the start of March 2020, Marsh has helped our clients free $3 billion from their captives.

Captives can help their parents respond to cash-flow challenges that arise during such situations in various ways, including:

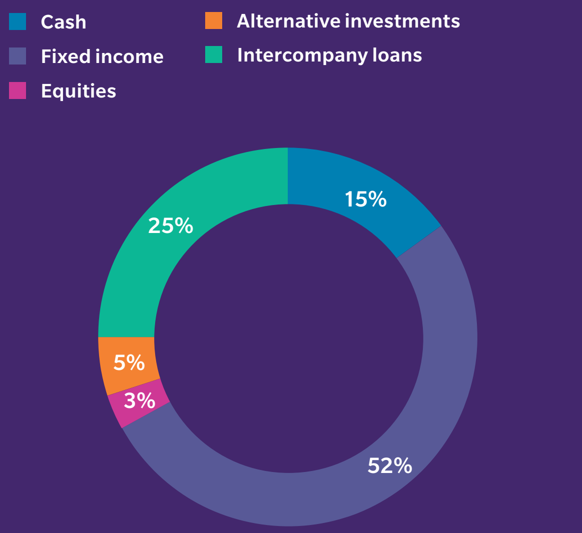
Short-Term Liquidity Tactics

Breaking the myth that captives trap cash, a captive's investment strategy can be adapted to both satisfy the captive's requirements and provide benefits to the parent organization.

- **Intercompany lending.** A captive's investments can complement its parent organization's investment strategies and build up significant surplus. This surplus can provide intercompany loans that are quicker and easier to arrange than bank credit facilities and enable parents to repay funds back into a captive. In 2019, a quarter of the total investments held by Marsh-managed captives were in intercompany loans, totaling $69 billion (see Figure 3).
- **Other parent company assets.** Though these transactions need to be discussed with internal and potentially external tax advisors, captives can often invest in parent company assets —

FIGURE 3

In 2019, Marsh-managed captives held 25% of all investments in intercompany loans.



including real estate and trade receivables. Total assets held within captives under management in 2019 amounted to $391.4 billion. When a captive purchases these assets for cash, they become part of its balance sheet — providing the parent with more cash to fund its operations.

Capital and Surplus

Marsh-managed captives have a combined $113 billion in total shareholder funds, which represents the amount by which assets exceed liabilities — an important element for any insurance vehicle. While regulators require captives to maintain a certain amount of surplus, excess surplus can be made available for other purposes, including liquidity needs such as:

- **Dividends.** A captive can build up its surplus by accumulating profits, which the captive can return to its parent by way of dividends. This is a relatively quick and easy process, but it requires calculation and regulatory approval in most jurisdictions.
- **Premium financing via discounts/premium holidays.** If it has sufficient surplus, a captive can offer its parent a premium discount or holiday for an upcoming renewal for first-party coverages. This can allow a parent company to retain more cash.
- **Risk management expenses.** A captive, rather than the parent organization, can pay for appropriate risk consulting projects, such as property engineering expenses and loss control programs.

Creating More Surplus

Making additional surplus available to the parent organization can help support liquidity needs. Beyond simply accumulating profits, there are medium- to long-term strategies that a captive owner can use to potentially generate more surplus:

- **Reserve reviews.** Using a systemic process, such as a claim inventory workout, can help to generate more surplus by lowering a captive's loss reserves.
- **Offloading older liabilities to a third party, or purchasing reinsurance.** In exchange for a payment to a third party, a captive parent can sometimes remove liabilities from its balance sheet and thereby reduce the ongoing expense to run off these claims. Typically, this is achieved by a novation and loss portfolio transfer agreement with a third-party commercial insurer, or through the sale of the captive in its entirety to a runoff insurance vehicle. Typically, achieving this finality has a price — and while there is some potential to unlock value, these long-term strategies can take several months to execute.
- **Purchasing reinsurance behind a captive.** This can lower overall surplus requirements, since a captive would retain less exposure as this is one of the primary benefits of owning and operating a captive.
- **Discounting loss reserves.** Working with a captive actuary and regulator, it may be possible to discount loss reserves, which would result in a lower book value and corresponding increase in surplus.
- **Adjusting premium-to-surplus ratios.** In some cases, regulators have allowed captives to maintain a higher premium-to-surplus ratio. For example, moving from a 3:1 ratio to a 5:1 ratio can result in both a lower surplus requirement for regulatory purposes and permission from regulators to increase loans and issue dividends.

Domiciles Note Captive Innovations

Regulators see captives embracing technology and third-party risks

US domiciles have seen significantly more growth in the number of captives over the last five years (20%) when compared to other global domiciles (1%). In 2019, US-domiciled captives accounted for almost half (45%) of gross premium written by Marsh-managed captives.

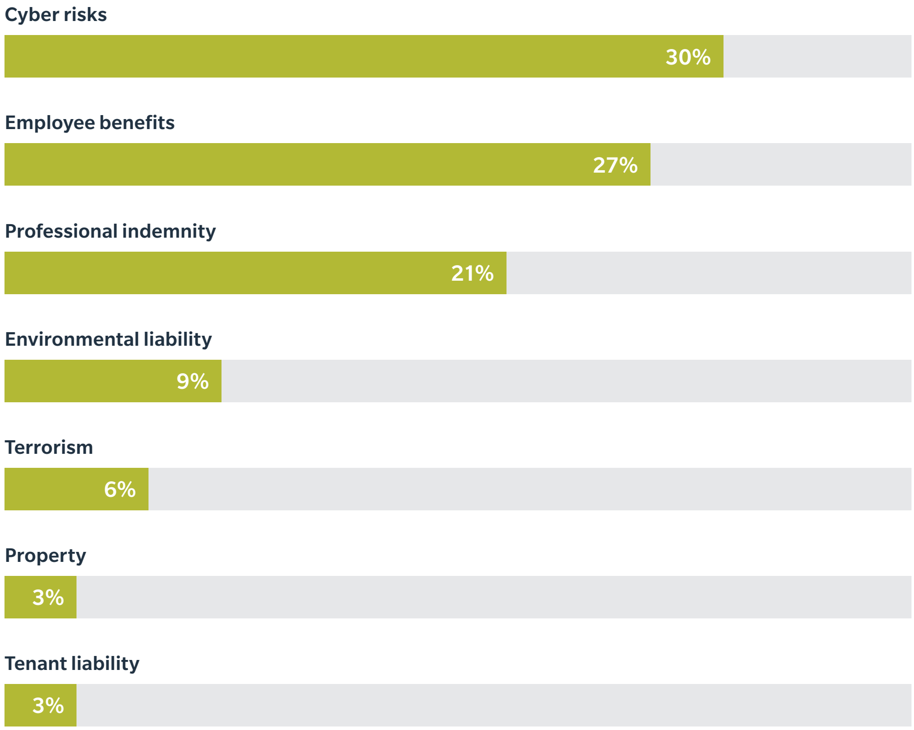
A Marsh survey of captive regulators around the world found that domiciles are seeing several trends in risks and lines of business as captives adopt increasingly sophisticated technologies. Nearly all regulators surveyed were open to the use of cryptocurrencies in captives, but 21% expressed uncertainty about its regulation.

More captives are writing cyber insurance, according to regulators, who saw that trend as both an opportunity and a threat (see Figure 4). They said the threat comes from the additional risk it presents to captives, as well as the governance and compliance it requires.

FIGURE 4

Cyber risk tops the list of new areas that regulators see captives writing more frequently.

SOURCE: 2020 SURVEY OF GLOBAL REGULATORS



Beyond cyber, regulators are seeing captives write more employee benefits, professional indemnity, and environmental liability. Third-party risks that domiciles see increasing include employee benefits, extended warranties, customer coverages, and supply chain (see Figure 5).

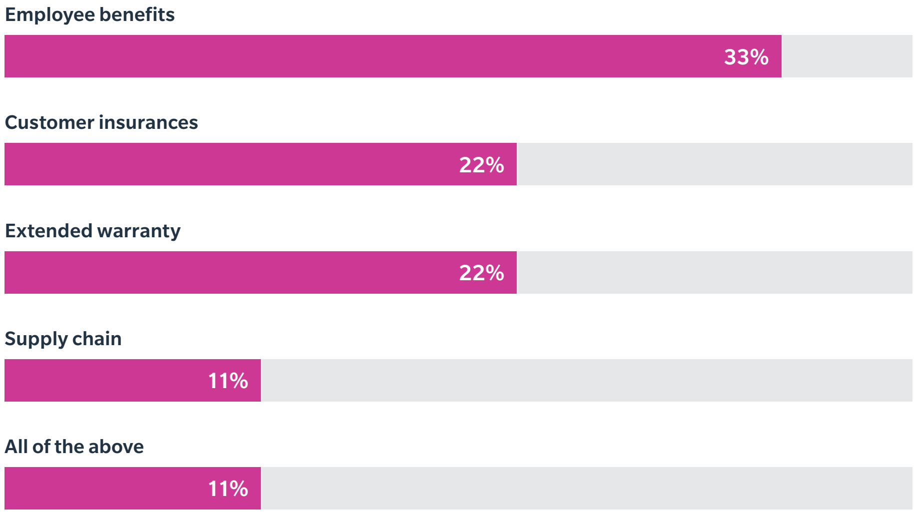
Regulators emphasized that good governance is essential to running captives effectively, such as having qualified, experienced experts on a captive's board of directors. Adapting to changes, including external tax laws and technological advancements, also is important in the growth of captives, regulators said.

The ability to design customized insurance coverages, access alternative capital, and generate profits through third-party business makes captives especially valuable during market transitions.

FIGURE 5

Regulators see employee benefits as the third-party risk that captives are writing most frequently.

SOURCE: 2020 SURVEY OF GLOBAL REGULATORS



Business Cases for Captives

Captives offer numerous advantages to their owners, which may include:

- Risk financing flexibility, particularly on risks for which commercial insurance is difficult or impossible to obtain.
- Reducing total cost of risk.
- Using and accessing capital efficiently.
- Protecting human capital and providing employee benefit incentives.
- Optimizing investment strategies.
- Safeguarding digital assets from cyber threats.

As a result, captive structures deliver value to risk managers, chief financial officers, treasurers, human resources leaders, chief information officers, and others.

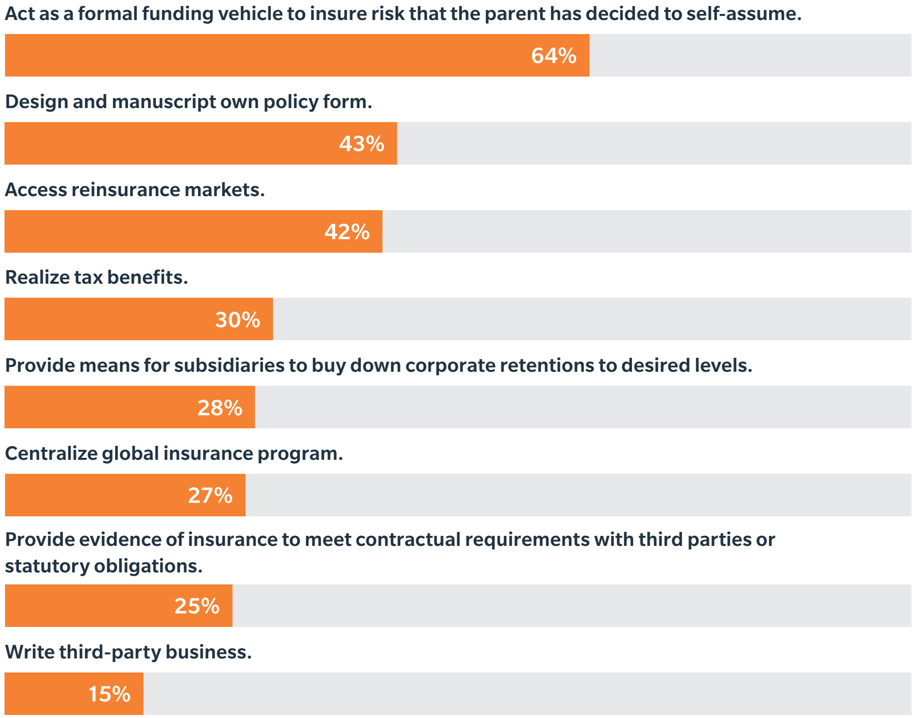
Key Value Drivers

A survey of Marsh clients with captives found the key value drivers in maintaining a captive (see Figure 6). These include acting as a formal funding vehicle for risks the parent organization has elected to assume, designing and customizing policy forms, and accessing reinsurance capital.

FIGURE 6

Insuring parent company risks tops the list of captive value drivers.

SOURCE: 2020 SURVEY OF MARSH CLIENTS



Transitioning Insurance Market

The client survey found that a majority of captive owners plan to increase their use of captives in response to changing insurance market conditions (see Figure 7). More than half (59%) expected to expand their captive use by adding more lines of coverage, increasing retentions in the captive, or forming an additional captive, while 38% said they had no plans to make changes.

Captives and D&O Liability

The evolving risk environment and the COVID-19 pandemic continue to challenge organizations and their directors and officers. Tasked with making difficult decisions to protect and promote their companies' viability, directors and officers increasingly are exposed to litigation and financial loss during times of transition.

Since 2019, pricing for directors and officers liability (D&O) insurance for public companies has increased by double digits — and grown each quarter. In the US, Marsh saw D&O pricing increase 59%, on average in the second quarter of 2020. More than 90% of Marsh clients experienced an increase, a figure that climbed to 99% among publicly traded companies.

As D&O losses have increased in frequency and severity, insurers have insisted that rates continue to materially increase. This pressure for buyers has manifested in primary, excess, and — more recently — Side-A premiums, which have been driven up by a steady influx of derivative claims and some large settlements.

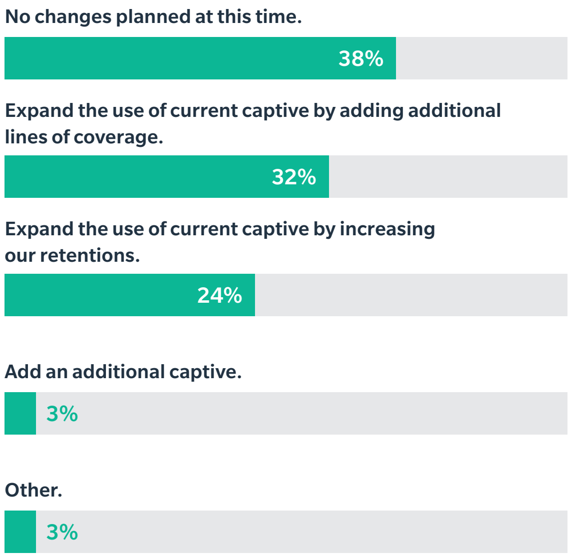
Given commercial market conditions, organizations are increasingly seeking alternatives for D&O insurance. Although a number of clients have insured Sides B and C (corporate risk) in a single-parent captive, financing Side A (non-indemnified loss) in a captive has proved challenging.

Side-A D&O coverage generally responds in the event that the company cannot, or will not, indemnify a director or officer. The reasons for the inability to indemnify are generally due to legal or corporate prohibitions, or to corporate insolvency. A concern with placing Side-A D&O in a single-parent captive relates to the actual or potential conflict that could arise in the event that the captive, a subsidiary of the company, is asked to pay a claim for a director or officer that the company is not permitted to indemnify.

Alternatively, a protected or segregated cell facility (PCC) is more arms-length from the company and therefore better suited to funding Side-A losses than a single-parent captive. A PCC is a standalone entity with ownership, management, and control largely independent of the company seeking to insure its directors and officers. Decisions related to the policy's response and the provision of Side-A D&O coverage can be independent of the company. Potential concerns about influence by the company's management and concerns about disgruntled shareholders should be ameliorated through a proper structure.

FIGURE 7 More than half of captive owners plan to expand their use.

SOURCE: 2020 SURVEY OF MARSH CLIENTS



One consideration in using a cell as a Side-A D&O option is transaction cost. The aggregate policy limit the cell writes must be fully funded through a combination of the premium plus collateral. Additionally, a cell's ability to successfully pay a claim has not been tested in court. These factors need to be considered when determining whether the use of a PCC is appropriate. To date, due to the challenges in the D&O marketplace globally, some Marsh clients have used cells for Side-A D&O coverage when traditional insurance has been unavailable or only partially available. Organizations with captives also are showing increasing interest in PCCs even where traditional insurance is available in the open market, due to cost considerations.

Employee Benefits

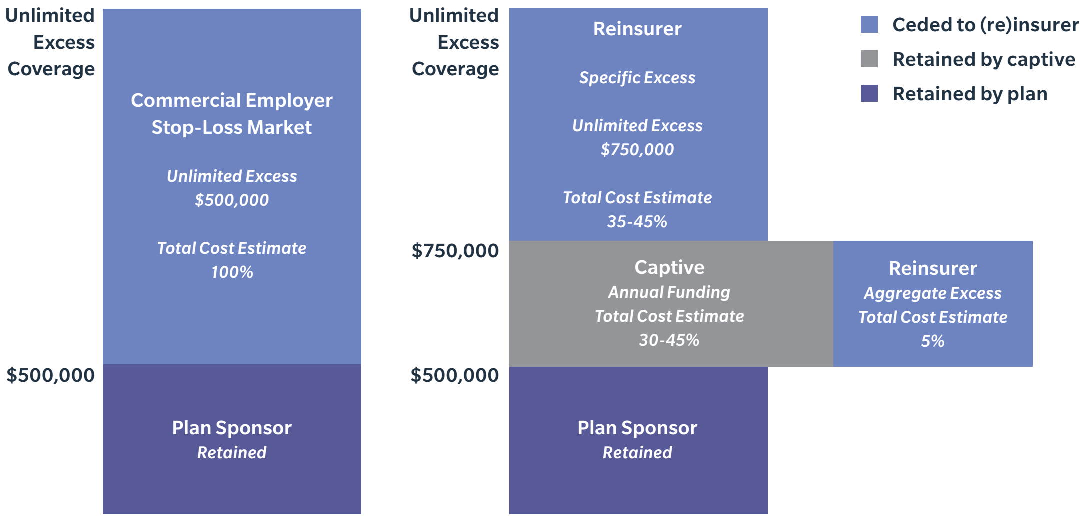
Employers that self-fund their health care benefits often use medical stop-loss coverage to provide greater control over plan costs, mitigate the expense of high-value medical claims, and achieve premium savings (see Figure 8). Over the past five years, the number of Marsh-managed captives writing medical stop-loss coverage has increased by 50%.

COVID-19 exposed inconsistencies in multinationals' benefit programs, showing that benefits available to workers in a few countries could vary greatly from those offered elsewhere. During the pandemic, companies have placed high value on employee assistance programs and telemedicine, which are likely to become more widely available. In another emerging trend, employers are providing additional indemnities and, in some cases, concierge services for employees hospitalized with COVID-19.

FIGURE 8

The number of captives writing medical stop-loss coverage has increased 50% in five years.

STOP-LOSS OPTIONS: COVERAGE ILLUSTRATION EXAMPLE



Marsh and Mercer jointly developed MedCat Re, a group captive program to provide coverage for catastrophic medical claims. The elimination of lifetime coverage maximums under the Affordable Care Act, along with the rising cost of treatments for rare diseases with specialty drugs, has led to a steep increase in catastrophic claims. MedCat Re provides coverage of $3 million excess of each $2 million claim through the group captive insurance company, with reinsurance for claims exceeding $5 million.

The use of captives to fund employee programs continues to increase. International benefits and programs for non-US employees have grown steadily for many years. In the past, a key factor in adding benefits to a captive was an owner's desire to achieve cost savings. While that remains an advantage, employers' main reason to write benefits through captives has shifted. Now, multinational companies especially are looking to create customized and consistent benefit programs that enhance the value proposition for current and prospective employees.

Captives' ability to write tailored coverages lets employers offer more benefit options and differentiate their programs. For example, captives can fund coverage for additional employee medical indemnities, along with certain treatments or chronic conditions that commercial insurance plans do not cover.

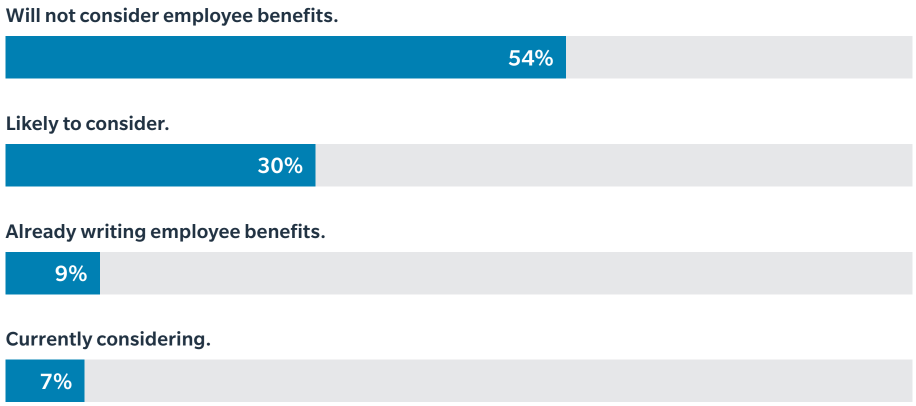
Unrelated to the pandemic, employers continue to focus on employee engagement and wellness programs, with incentives for meeting certain health goals. Captives can provide funding for such programs, which aim to increase employee satisfaction and retention. Captives give employers greater control of their benefit offerings and enable employers to create consistency in terms and conditions across geographies.

In the US, federal law requires employers to seek permission from the Department of Labor to fund benefits for domestic employees. Obtaining approval to write benefit programs for US workers historically has been a lengthy process. Nevertheless, a significant percentage (46%) of Marsh clients with captives say they are likely to consider adding benefits to their captives, are currently considering doing so, or are already writing employee benefits (see Figure 9).

FIGURE 9

Nearly half of captives are considering or already writing employee benefits.

SOURCE: 2020 SURVEY OF MARSH CLIENTS



IN FOCUS

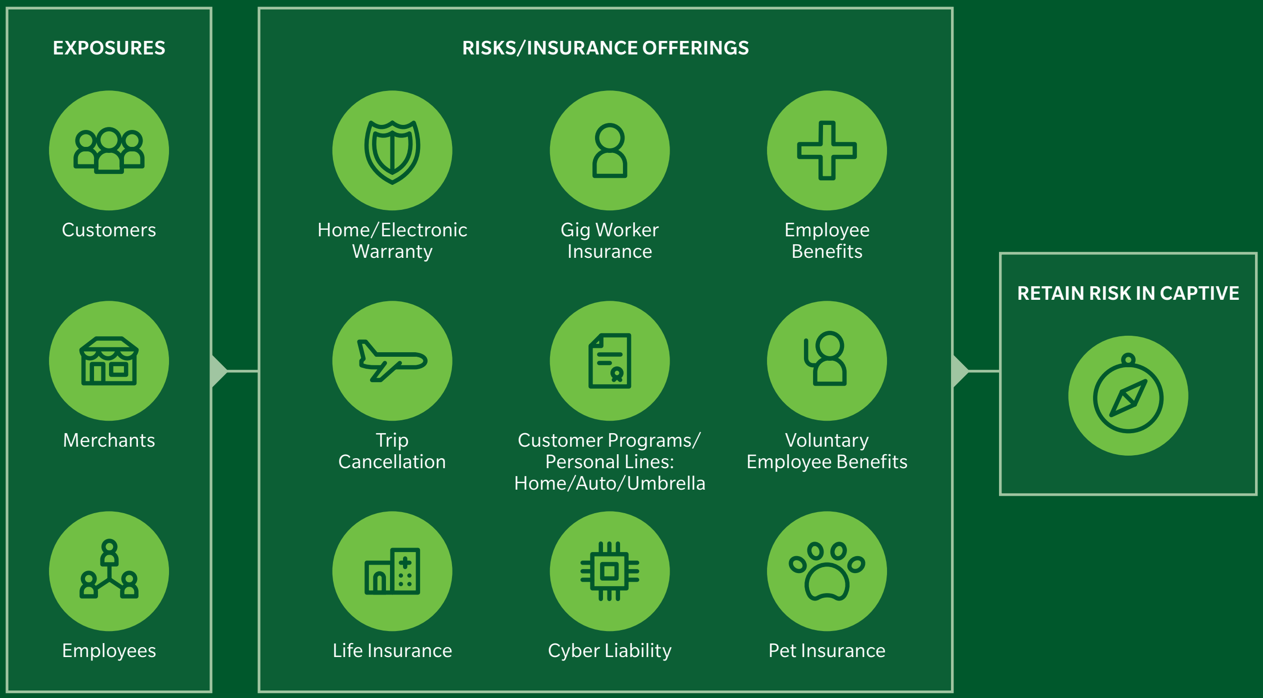
Third-Party Risks

Captive owners and customers each gain advantages

Most organizations form captives principally to fund their self-insured risks, however, they can reap additional advantages by writing third-party risks (see Figure 10).

From extended warranties to contract vendor liability, captives can insure many different third-party exposures and create a profit center for their parent organizations, diversify the risk in their captives, and improve relationship with end customers. Customers and vendors, meanwhile, can gain access to lower-cost coverages and build a better relationship with the captive parent.

FIGURE 10 Captives can benefit by writing third-party risks.



About 18% of Marsh-managed captives in 2019 wrote third-party property and casualty coverages. In 2019, Marsh-managed captives' third-party premiums increased by $1.2 billion. Some common third-party risks in captives include:

- **Extended warranties.** Warranties can provide protection on a variety of assets, from computer equipment to personal electronics to automobiles. Over the past five years, Marsh-managed captives' premiums for extended warranties rose by 28%.
- **Independent contractor/customer risks.** The ability to offer contract vendor liability protection fueled steep growth in this third-party risk. Over the past five years, premium volume for contract vendor coverage has soared more than 200%.
- **Affinity risks.** One attraction of affinity programs is that they provide lower-cost coverage and nurture relationships with homogeneous groups of customers. Examples of third-party affinity risks are personal property and liability insurance, credit disability, and travel accident insurance. Bluestream, a Marsh platform, provides a flexible way for captives and commercial insurers to deliver products digitally. Bluestream is a digital hub for vendors or consumers to purchase insurance products that can scale to create new revenue streams with customers and/or suppliers. It can facilitate third-party business in captives.

18%

Marsh-managed captives writing third-party property and casualty coverages in 2019.

$1.2 billion

Increase in Marsh-managed captives, third-party premiums in 2019.

A Global Overview of Captives

Captives Writing Diverse Risks

Globally, captive utilization continues to soar as evidenced by growth in the various lines of coverage written (see Figure 11). The main reason for this increase is the tightening of the insurance market. Increases in "all-risk," D&O, supply chain/BI, and CBI point to a dramatic change on the horizon for next year. Coverages written by Marsh-managed captives that have shown steep growth in gross premiums by percentage in the past year include many nontraditional lines.

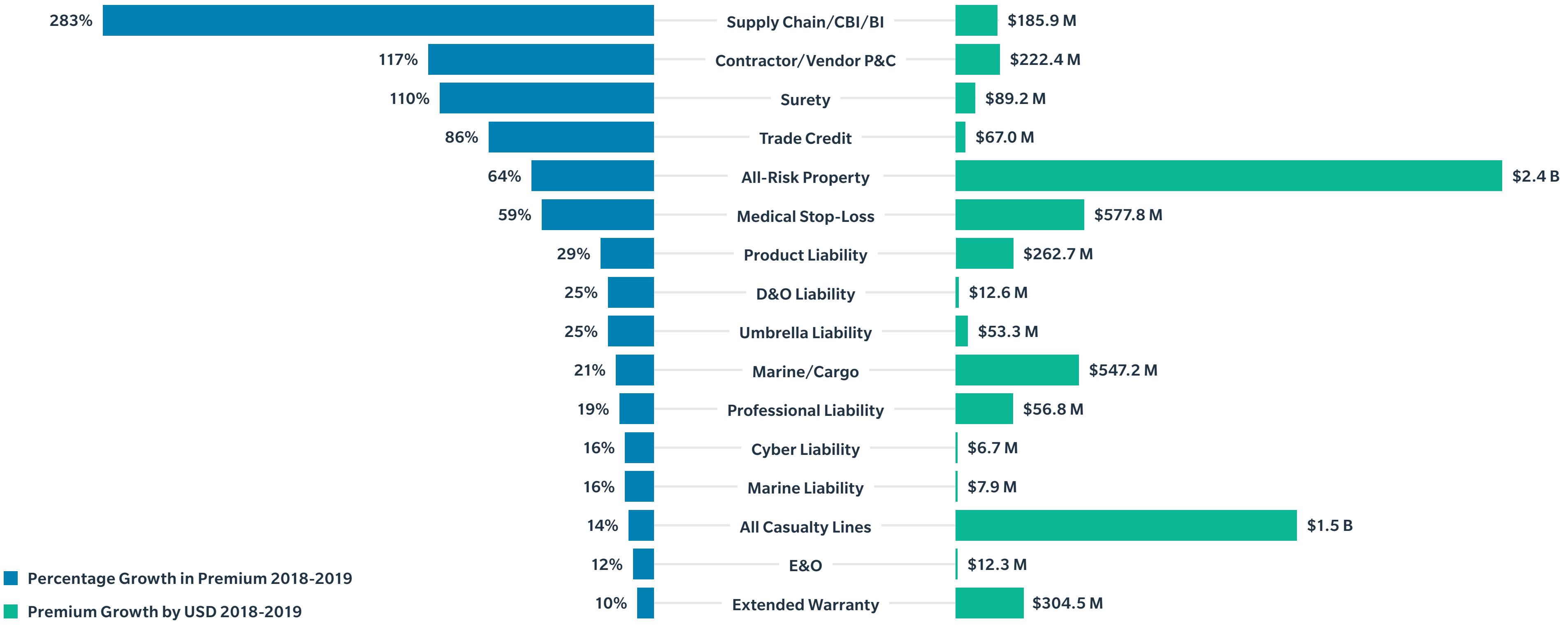
Exposures influenced by changes in credit markets, investment yields, tariffs, and trade can make commercial insurance options less financially attractive. As a result, more captives are insuring risks such as trade credit and surety, and funding longevity risks.

- **Trade credit.** For domestic or foreign suppliers, trade credit insurance through a captive allows parents to protect their receivables and safeguard payment of contractual obligations.
- **Business interruption.** At a time when many commercial insurers are backing away from covering business interruption risks due to contagious diseases, captives can write policies without such exclusions. Similarly, captives can support their parents' supply chains by offering third-party risk management solutions.
- **Surety.** Bonding facilitates corporate development, but market dynamics can cause surety companies to alter their appetites and pricing. When written through captives, surety bonds can cover a diverse array of corporate projects and enable continuous protection.
- **Benefit funding obligations.** Pensions and life insurance benefits are long-term financial obligations. Captives can offer cost-efficient ways to finance pension risks and life insurance programs.

When considering the data by growth in dollar amounts, another picture emerges: From 2018 to 2019, traditional lines increased due to issues in the conventional insurance market (see Figure 11). The sheer premium volume in these "core" lines translates to large dollar amounts, even when the percentage growth is not as notable.

FIGURE 11

Premium growth in captives shows continued increase in utilization, while captive premiums in traditional lines have also grown.



Onshore or Offshore

Globally, there are more than 60 captive domiciles. Slightly more than half of Marsh-managed captives are based in onshore — defined as Australia, Dublin, Luxembourg, Malta, Singapore, Sweden, and the US — or domestic domiciles. The mix of onshore and offshore domiciles has remained relatively consistent in the past seven years (see Figure 12). Offshore domiciles account for all other regions not noted as being "onshore."

Size Trends

Over the past five years, midsize captives — those with premiums between $5 million and $20 million — have shown the most growth (see Figure 13). Jumbo captives — with more than $20 million in net premium — have remained relatively stable.

FIGURE 12 Onshore captive domiciles are slightly more prevalent than offshore domiciles.

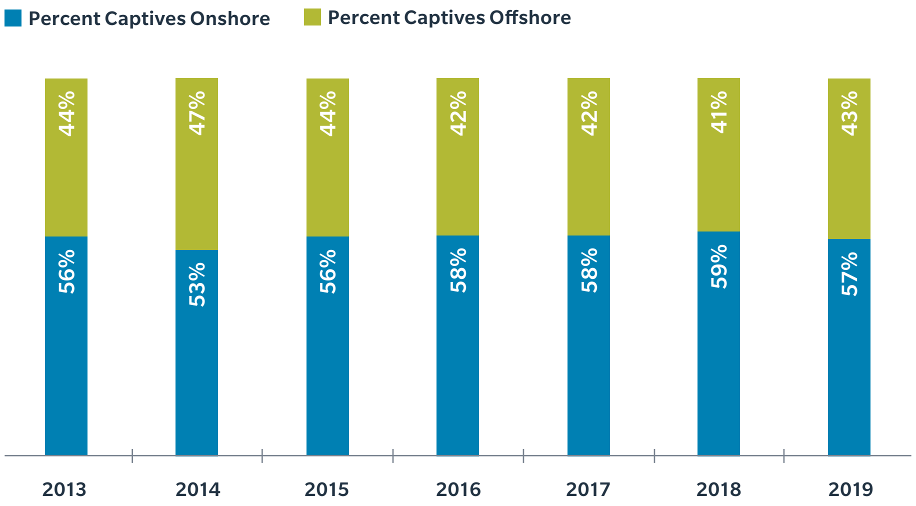
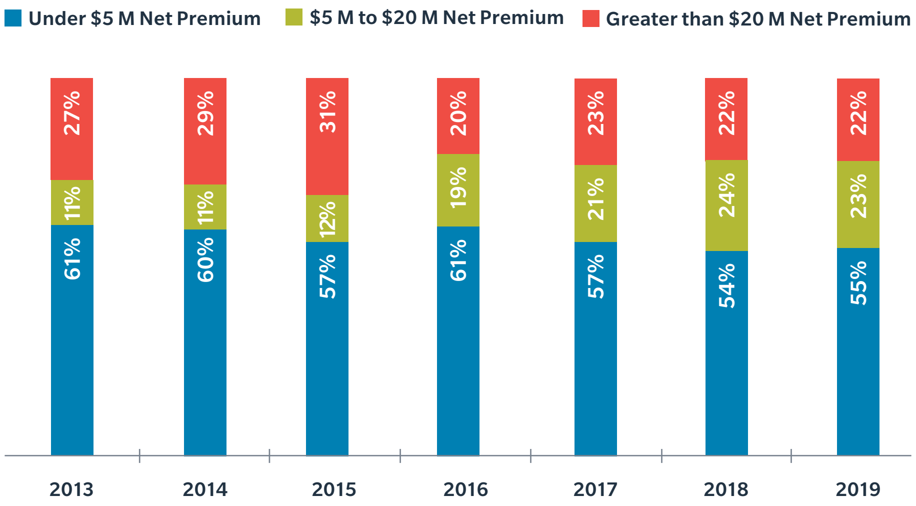


FIGURE 13 Midsize captives are growing more quickly than larger ones.



Captives by Industry

Financial services and health care remain anchor industries by number of captives and premium volume, but many other industries are expanding their use of captives (see Figure 14).

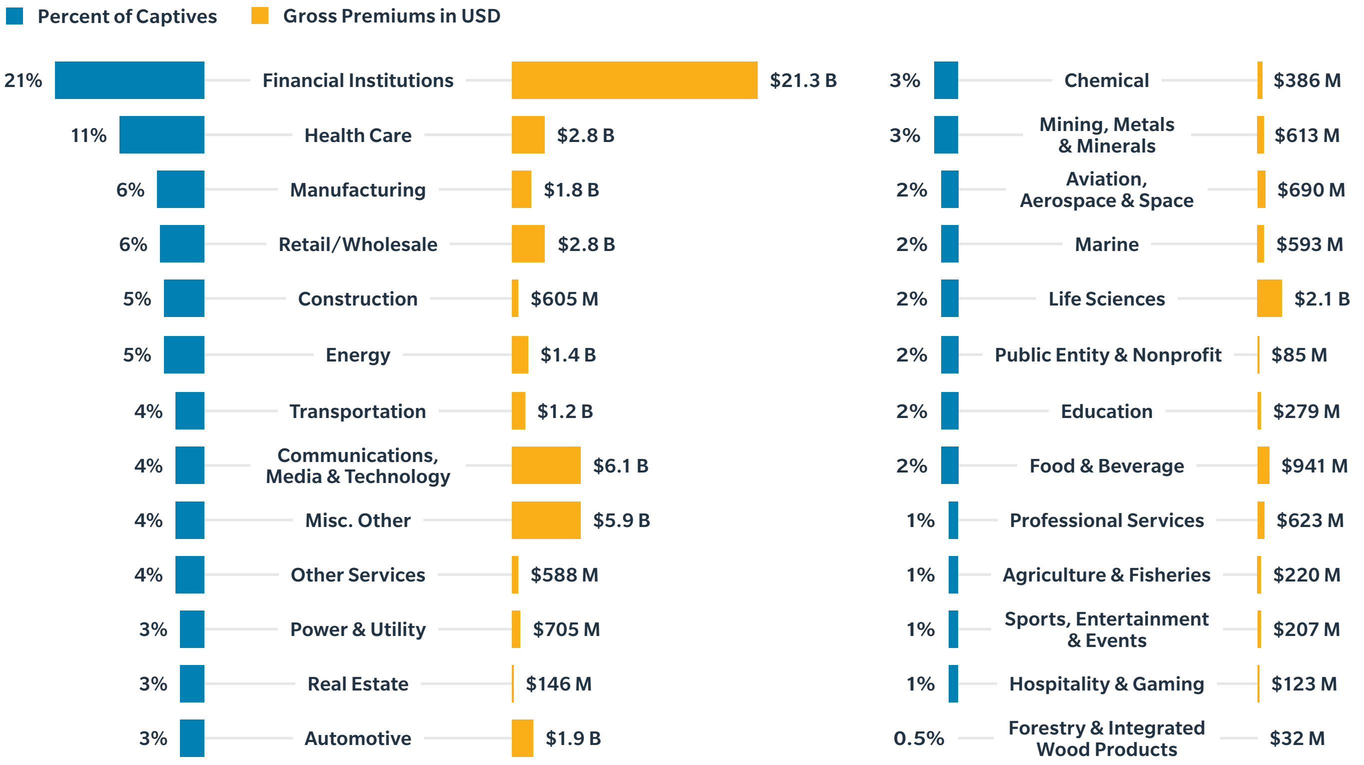
As a result of the transitioning insurance market, industry-specific trends have begun to emerge around the increased use of captives in certain lines of business. While there was a 64% year-over-year increase in “all-risk” property premium across all industries, the following industries have seen higher than average “all risk” premium growth when compared to Marsh-managed captives as a whole:

- Energy: 151% increase.
- Financial institutions: 104% increase.
- Communications, media, and technology: 98% increase.
- Construction: 97% increase.

Other industries have expanded their captive use in specific ways. For example, there was a 72% year-over-year increase in product liability premium among manufacturing industry captives as commercial insurers increasingly require organizations to take higher retentions.

FIGURE 14

Financial services top captives by industry in premium volume.



In the last year, excess liability capacity began to shrink in the commercial market. Some organizations are filling gaps in their excess liability towers by using their captives. This is especially true in health care, which saw a 33% increase in excess premium in 2019 compared to 2018.

In construction, reaction to increased market pricing resulted in a 200% increase in professional liability premium being driven to captives in 2019. Interestingly, there has also been a 44% increase in third-party contractor and vendor programs.

Parent Company Regions

By regions where captive parents are based, captive growth over the past five years has largely occurred in emerging markets, led by Latin America and Asia-Pacific, with 10 and 20 new captives respectively, largely due to the pronounced Australian insurance market challenges. While more parents in Latin America and Africa are forming captives, their overall number of captives remains low; continued growth is expected in these regions as the concepts of alternative risk financing and captive use is more widely accepted. In Europe, the overall number of captives has remained flat, but premium volume has increased by 8% year over year.

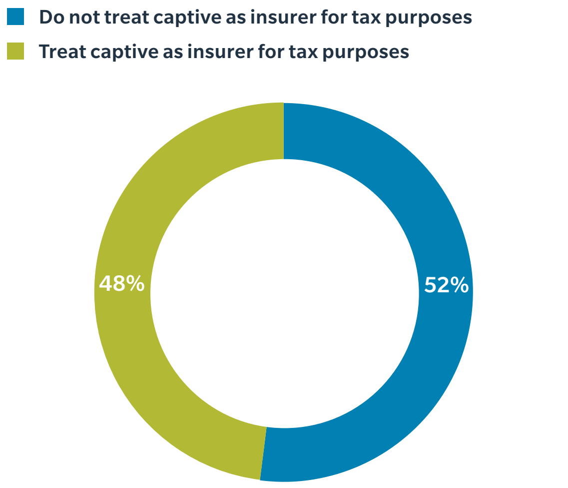
Tax Benefits

Under specific circumstances, captives can offer their parents tax efficiencies, such as deductibility of premiums. In 2019, only 30% of Marsh clients cited tax benefits as a key value driver for their captives. Less than half (48%) of US companies owning captives treat their captives as insurance companies for federal income tax purposes (see Figure 15).

To qualify captive activities as insurance to meet US federal income tax classification, a captive owner must demonstrate risk diversification. Among Marsh-managed US captives, 46% use third-party risk as their primary method of risk diversification.

FIGURE 15

Less than half of US captive owners treat their captives as insurance companies for tax purposes.



Regulatory Update

A variety of regulations with an impact on captives and commercial insurers went into effect in 2019 and 2020. Among these were:

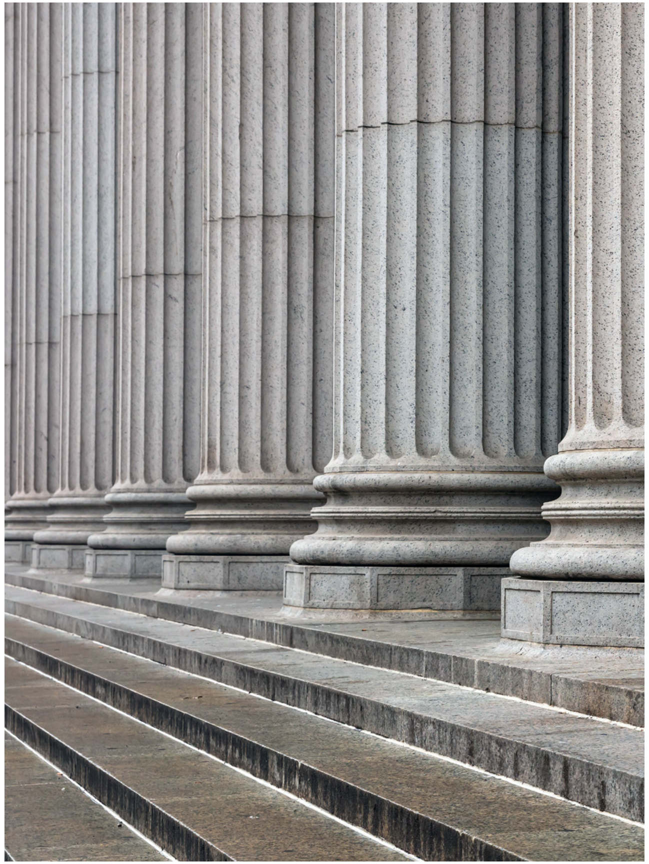
- **Terrorism backstop extension.** Captive owners have an excellent opportunity to include terrorism risks in their captives after the Terrorism Risk Insurance Program Reauthorization Act (TRIPRA) was extended through 2027. Over the past five years, the number of Marsh-managed captives writing TRIPRA increased by 49%. Under the federal backstop, captives are specifically included if they write eligible lines of terrorism insurance. Such captives are required to take part in data calls, which provide the US Treasury Department with information to analyze the availability of terrorism insurance. Captives that purchase terrorism reinsurance should review their capitalization and may need to update policies and procedures.

- **Mandatory disclosure reporting.** The European Union's 6th Amendment to its Directive on Administrative Cooperation established a mandatory disclosure reporting regime, which requires intermediaries to disclose to tax authorities certain cross-border transactions dating back to June 25, 2018.

Other captive-related regulatory developments include:

- **International financial reporting standards.** IFRS 17 is a new accounting standard for insurance and reinsurance contracts, expected to take effect in 2023, though affected captives will need to be ready by 2022. The standard requires additional analysis and disclosures for certain contracts and may apply directly to captives in domiciles where IFRS reporting has been adopted, or may impact consolidation if a parent is subject to IFRS reporting.

- **Washington state legislation.** Before the pandemic, the state of Washington was considering enacting legislation that would provide a legal framework for captive insurers to write risks there. Although the legislation would not authorize formation of captives based in Washington, it would clarify rules on self-procurement of insurance and premium taxes paid by out-of-state captives. The legislation is delayed until at least 2021 due to COVID-19.

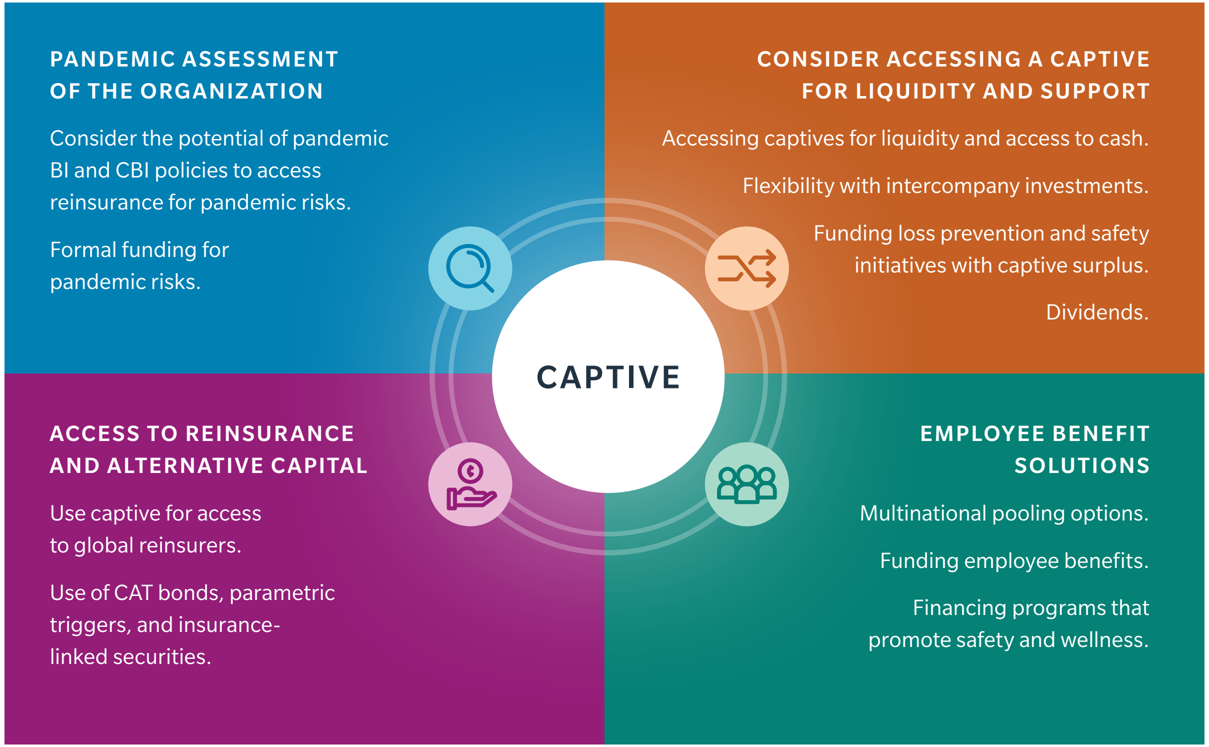


Recommendations

Captives are highly flexible vehicles that can evolve to help their parent organizations navigate through uncertainty and market transitions, providing value in uncertain times. Captive owners should consider a range of issues to help make sure they are ready to meet today's challenging business environment (see Figure 16).

Regardless of whether an organization uses a captive to respond to extraordinary situations such as the COVID-19 pandemic, it is important for all captive parents to model their exposures and integrate captives into strategic planning and funding decisions. Parents should examine global risk dynamics not only related to their organizations, but in their industries. Putting a captive at the center of their risk management strategy and exploring different uses of a captive enables organizations to gain multiple advantages and protect their future.

FIGURE 16 Put a captive at the core to navigate complex global risks.



ABOUT MARSH

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ABOUT THIS REPORT

Except as indicated, all data in this report is based on approximately 1,240 Marsh-managed captives that agree to share their data on an anonymous and aggregated basis. Clients can opt out of the analysis.

For more information, contact marshcaptivesolutions@marsh.com.