Developing captives in a hard market

Even if you don't know much about captive insurance, you'll appreciate why there has been a direct correlation between the number of new captives formed and the state of the insurance market. In a hard market, when insurance rates are considered high, there is more interest in self-insurance, which often leads to the formation of new captives.

What causes a hard market? Clearly anything that negatively impacts the results of the insurance market such as an increase in claims. In turn, claims can be triggered by events ranging from earthquakes to civil unrest. When insurers start suffering losses, the first thing they do is increase their premium rates, which will eventually cause a hard market.

Therefore, the state of the global insurance and reinsurance market directly impacts the growth of the captive insurance market, and is closely monitored by the brokers and consultants who promote captives and other forms of alternative risk financing.

Having said that, despite all the natural disasters we have had in previous years, the annual year end renewals in January 2012 marked the 8th consecutive year of soft market pricing in the property and casualty insurance industry. With rates continuing to fall as carriers compete with one another for customers, this eight year stretch is now the longest soft market in 70 years.

However, are things about to change? It seems that every week we hear about yet another natural disaster. Since September 2010 we have had a spate of particularly large natural disasters resulting in very expensive large insured losses such as the two earthquakes in New Zealand (est. $15bn), the tragic and devastating "Great Tohoku" earthquake in Japan (est. $39bn), the significant flooding caused by Cyclone Yasi in Australia (est. $7.5bn), and the US tornadoes (est. $10bn).

These few events represent insured losses in excess of $70bn. This is an enormous amount of money and surely the insurance market has to harden?

But no, there is still plenty of capacity out there.

Twenty years ago, an accumulation of events like this would have flipped the global insurance market from soft to hard over night. The difference nowadays is that the reinsurance capacity available is so enormous that it is more than able to support this spate of large insured losses. The global reinsurance capital is estimated to be in the region of $440bn, with an increasingly significant amount of that being provided by the capital markets. The insurance related capital market instruments were created and first used in the mid-1990s in the aftermath of Hurricane Andrew and the Northridge earthquake, and are becoming increasingly popular.

The most common form of capital market instrument is the catastrophe bond or “cat bond”. An insurance company issues bonds through an investment bank, which are then sold to investors. These bonds are inherently risky, and are multi-year deals. If no catastrophe occurs, the insurance company pays a coupon to the investors, who make a healthy return. On the contrary, if a catastrophe does occur, then the principal is used by the insurance company to pay claims.

Index-linked securities, and catastrophe bonds in particular, have grown and developed ever since to include other such instruments as industry-linked warranties, sidecars and, more recently, shelf sidecars. All of these are now vital components of the world of alternative risk financing, and provide additional capital to the reinsurance market.

The July 2011 Reinsurance Market Outlook produced by Aon Benfield Analytics stated that: “Reinsurance capacity remains abundant despite the Tohoku earthquake, and events in New Zealand and Australia. The impact on many reinsurers is relatively small, resulting in overall capital reduction of approximately six per cent since year end 2010 and is well above the earlier peak in 2007. Demand over the same period has changed minimally, suggesting that reinsurers still have ample capacity to provide the limit desired by clients.”

Clearly, rates in proven hazard countries like Japan have already risen, and as a direct result of this so has the interest in index linked securities. Goldman Sachs predicts that in 2011 there will be between $1bn - $2bn post-Japan sidecar issuance alone, which is excellent news for the insurance bond industry. Even though the full impact of the riots in London and Hurricane Irene in the US and floods in Thailand are as yet unknown, global property and casualty rates are expected to remain soft for the time being. However, a number of experts believe that they will harden in 2012, resulting in the end of the soft market.

Based on the continuing soft market described above, one would expect there to have been little growth in the establishment of new captives around the world, and this is at least partially correct. I say this because one jurisdiction seems to be bucking the trend, and that’s the Cayman Islands. What does Cayman do that is so special or different from other captive centres? Why have 38 new captives set up there in 2011, thirteen more than in 2010?

The answer lies in the fact that although Cayman is well known as a leading centre for traditional property and casualty captives, it is perhaps better known as the complete global financial centre. Cayman is home to 70% of the world’s funds, it has over 90,000 active registered companies and in 2010, 8,000 new companies were incorporated. It has an active banking industry and particularly vibrant trust and corporate services sectors.

To service all these sophisticated financial companies, Cayman has an exceptionally gifted pool of professional service providers, which includes lawyers, accountants, bankers and insurance managers. Cayman law firms are busy opening offices all over the world, which attract more and diverse business to the jurisdiction.

It's these other non-insurance services which help differentiate Cayman from other jurisdictions. With regards to insurance, Cayman hasn't limited itself to traditional property and casualty captive insurance companies, but has extended its offering to include wholesale reinsurance, cat bond reinsurance (as described above), life and annuity insurance and segregated portfolio legislation. It has also developed specialism in healthcare business.

This explains why 36 special purpose vehicle insurance cat bond reinsurance companies are based in Cayman, why there are over 600 segregated cells in Cayman and why there are 256 captives writing medical malpractice insurance. It's for these reasons that Cayman would be better described as a centre for international insurance rather than simply a centre for captives.

The international insurance industry is of enormous benefit to the Cayman Islands, and the government certainly appreciates the benefits of the industry's annual written premiums of US$11.8bn and assets under management of US$68.5bn. In fact, it is estimated that the insurance industry in Cayman contributes approximately $90m per year to Cayman's GDP. This revenue comes from government and service providers' fees, and also from the many visitors who come to Cayman for board and other meetings with their service providers or the regulator. This indirect revenue from visitors comes from the cost of transport, hotels, restaurant and social activities. Another important differentiating feature about Cayman is the success of its annual Captive Forum held in November/December every year. In 2011, 1,300 people attended, which makes it the largest captive conference anywhere in the world, and the largest conference of any kind in Cayman. It's no wonder that the Cayman government, through its Financial Services Secretariat, is happy to provide as much assistance to the industry as it can.

In conclusion, nobody is really sure how long this record soft market will continue, but it's clear that it will only be those jurisdictions which have the necessary innovation, intellect and integrity to continually develop that are likely to see growth in the future.

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