captive insurance times

The primary source of global captive insurance news and analysis

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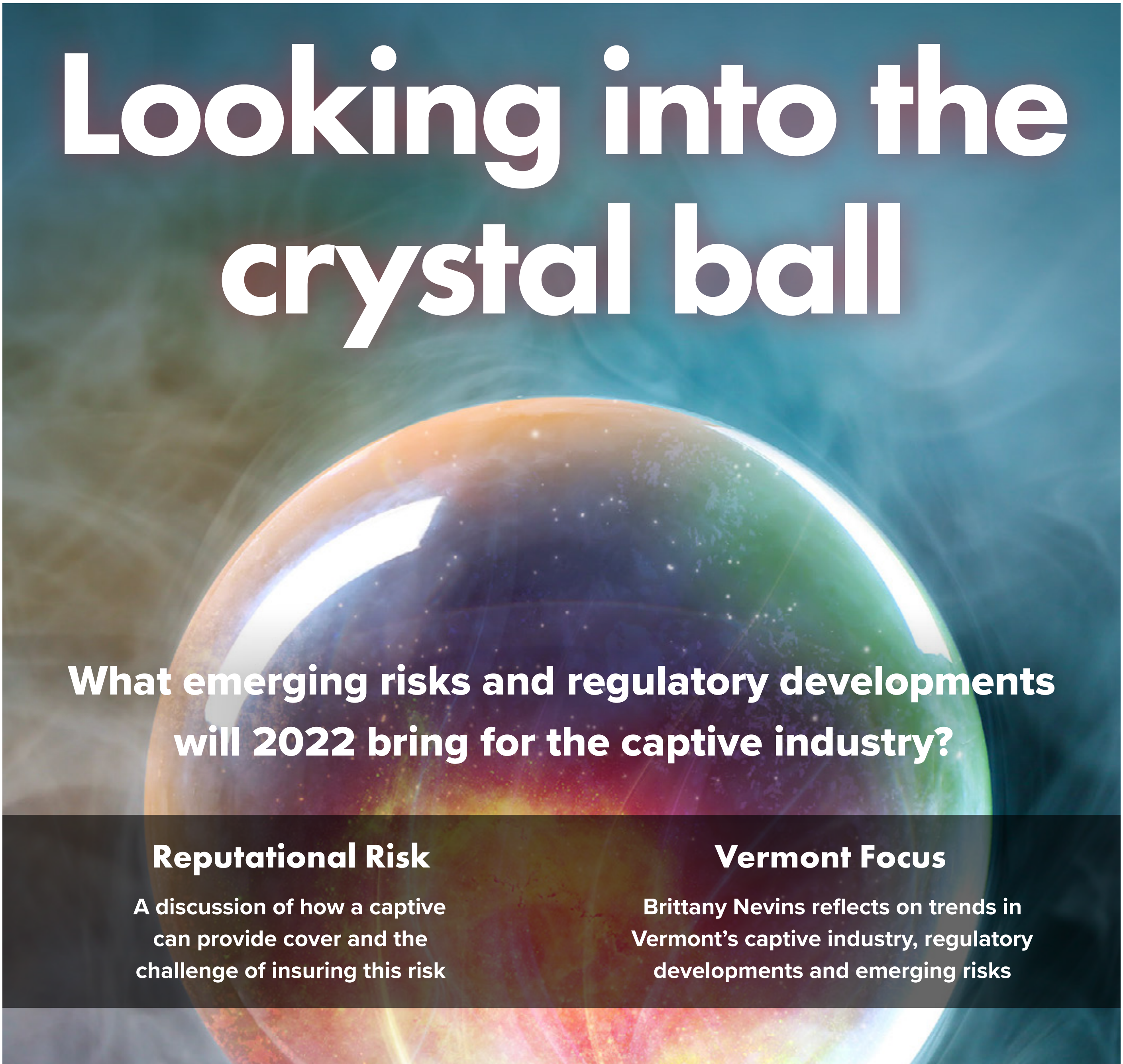

Looking into the crystal ball

What emerging risks and regulatory developments will 2022 bring for the captive industry?

Reputational Risk

A discussion of how a captive can provide cover and the challenge of insuring this risk

Vermont Focus

Brittany Nevins reflects on trends in Vermont's captive industry, regulatory developments and emerging risks

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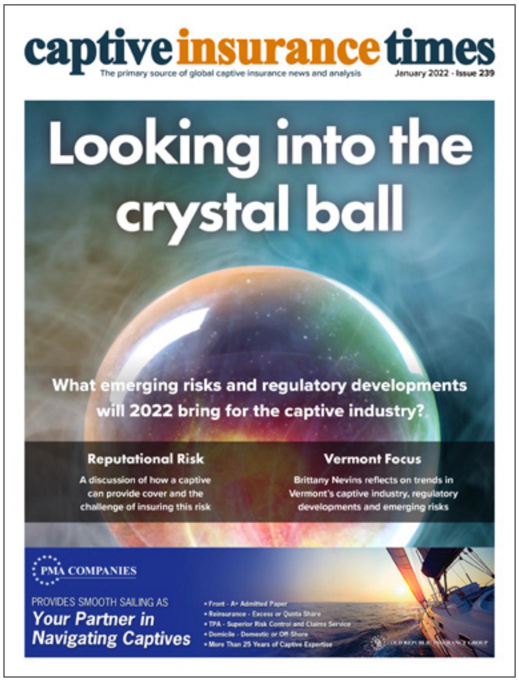

In this issue

A.M. Best: Climate risk provides both opportunities and challenges for reinsurers

Innovation within the insurance industry to address evolving climate risks could see business opportunities for captive insurance, according to an A.M. Best special report, 'Insurance innovation under the spotlight after COP26'.

The United Nations COP26 meeting saw world leaders agree on ambitious plans to reduce carbon emissions and protect communities and natural habitats from the effects of climate change.

The A.M. Best report states that the transition to a low-carbon economy provides reinsurers with a variety of underwriting opportunities and challenges.

Opportunities arise from the role of reinsurers as institutional investors, which allows them to help generate funds to support the development and scalability of the new technologies required for decarbonisation.

The resilience of policyholders can be strengthened through enhanced loss prevention, adaptation and efficient claims payments. In terms of these underwriting opportunities, the rating agency says: "A.M. Best expects reinsurers to become increasingly innovative as they evolve to cater to the changing needs of societies. In this context, it is expected that existing insurance solutions and products will evolve, and new ones will emerge that address the evolving risk universe."

The report adds: "Shortage of insurance capacity could fuel business opportunities in the captive insurance space."

Reinsurers are in an important position to make a "unique contribution" to climate risk innovation, including new product development that incorporates social and environmental values.

Other examples of insurers' innovation in their fundamental role as risk managers include enhanced modelling of climate risks, the use of more sophisticated early warning systems (for natural catastrophes), and retrofitting of buildings to ensure resilience (particularly for flood risk).

A.M. Best observes an increasing interest in parametric covers within product design and distribution, which the rating agency notes are relatively easy to understand, as well as reduce dispute risk and enable quick indemnification of impacted communities.

The report warns that owing to the accelerating pace of change in global operating environments, insurers that fail to embrace innovation may find it difficult to sustain long-term success. ■

Coalition to launch captive for cyber risk

Commercial insurtech provider Coalition is set to launch a new captive to take risk on its cyber insurance programmes.

The captive will consolidate Coalition's ability to manage capacity, as well as support long-term growth objectives while aligning incentives with clients.

Coalition's underwriting model of risk management is based on its broker platform, which employs real-time security, financial, regulatory and transactional data to efficiently generate quotes for cyber risk insurance and security.

Dovid Tkatch, Coalition's head of insurance infrastructure and actuarial science, will oversee development of the captive, as well as pricing, reserving, capital requirements and regulatory compliance.

Shawn Ram, head of insurance at Coalition, comments: "This demonstrates our unwavering commitment to protecting businesses from cyber risk, and our confidence in Coalition's approach to underwriting and risk management."

"With our new captive, we add another layer of security and stability, and more closely align our financial incentives with our customers."

Risk manager Davies acquires actuarial consulting firm

Professional services and technology firm Davies has acquired US-based insurance

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actuarial consulting firm Merlinos & Associates to strengthen its global insurance services offering.

Merlinos administers compliance, risk management and wider actuarial consulting services to the property, casualty, life and health insurance markets in the US.

The acquisition follows Davies' diversification of its global insurance services capabilities to provide audit, subrogation management and insurance-focused actuarial consulting for clients. For example, last September Davies acquired Asta, a third-party managing agent at Lloyd's.

This is alongside Davies' existing offering of insurance management solutions for captives, managing general agents and brokers across the risk and insurance value chain, such as claims, underwriting, distribution, regulation and digital transformation.

Under the acquisition agreement, Merlinos will form part of Davies' global insurance services business, led by CEO Steven Crabb, while the current management will report to Robert Dewen, Davies' insurance services US CEO.

Commenting on the acquisition, Dan Saulter, group CEO of Davies, says: "Merlinos is a fantastic fit for us, bringing a wealth of experience serving the insurance market with a diverse outlook and international client base of insurers, public entities, captives and self-insured entities."

"The expansion of our operations across North America with additional and new high value services capability continues to be an important strategy for Davies. It significantly enhances our existing actuarial services capability and will accelerate growth in this high value service space," Saulter continues.

Paul Merlino, president of Merlinos, adds: "We are delighted to be joining forces with Davies and to contribute to the success of its growth strategy in North America. We

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look forward to working with the wider Davies team to continue our client-centric focus and offer expanded insurance services and related state of the art technology investments from the broader Davies group."

Avrahami advisor protests IRS penalties

Celia Clark, the lawyer that helped to form the micro captive insurance company in the landmark Avrahami case, has filed a lawsuit against the Internal Revenue Service (IRS) seeking refund for the partial payment of penalties imposed under Section 6700 of the Internal Revenue Code (IRC).

Originally tried in March 2015, the case of Avrahami v Commissioner concerned the owners of the micro captive company Feedback, which provided direct property and casualty coverage to entities such as real estate ventures and shopping centres, as well as reinsuring chemical and biological terrorism coverage.

In the first court decision assessing the tax treatment of micro captives, the US Tax Court backed the IRS' decision to deny the Avrahamis access to the Section 831(b) election of the IRC for certain financial years.

Following denial of a motion for reconsideration, in July 2019 Benyamin and Orna Avrahami launched a class-action lawsuit against the original owners of Feedback, including Clark as a named defendant, claiming they failed to properly apply captive insurance strategies that caused the Avrahamis to incur back taxes, interest and penalties.

In the new lawsuit filed with the US District Court for the Southern District of Florida, Clark brings a suit for refund of her partial payment of penalties under Section 6700 for tax years 2008 to 2016.

The IRS had assessed more than US$11 million in penalties against Clark for her role in advising and assisting with the creation of micro captive insurance companies for her clients.

In the suit, Clark argues that "Congress has explicitly encouraged and promoted micro captive insurance companies by conferring upon them favorable tax treatment under section 831(b)".

The filing adds: "The IRS has sought to destroy the micro captive insurance industry. It has not done so by promulgating regulations, issuing revenue rulings, or providing affirmative guidance that taxpayers and tax practitioners could follow."

"Rather, the IRS has engaged in the unlawful "administrative repeal" of Section 831(b), thwarting Congress' intent by wrongfully penalising taxpayers and practitioners in the micro captive space, in a concerted effort to drive them out of that business."

The suit argues that the IRS' approach to penalty examination was abusive because it allowed for potential penalties to accumulate over nine years rather than providing clarity.

Clark contends that she would have litigated in a good faith disagreement until the matter was decided had she been aware of the IRS' ongoing examination, citing the closure of her practice after the Avrahami ruling as a demonstration of good faith.

In addition, the suit argues the IRS acted in an abusive manner as the agency prohibited Clark from litigating the advantages of micro captive company taxation as a non-party in the Avrahami case, which prevented her from participating in the trial (other than as a witness) or presenting a defense of herself.

The suit filed with the Florida district court also sues for unlawful disclosure of Clark's protected return information under IRC Section 7431.

Clark requests the court grants relief in the form of a refund of the $1,745,544 previously paid in penalties, abatement of the remaining penalties, and a grant of $1,000 for each individual act of unauthorised inspection or disclosure of return information, or else a sum of the actual damages sustained as a result of such unauthorised inspection or disclosure.

Willis Towers Watson places parametric solution for sovereign debt

Willis Towers Watson's alternative risk transfer division has designed and placed the world's first parametric insurance transaction to support the Government of Belize's debt restructuring for marine conservation.

The parametric solution is designed to improve the economic and environmental resilience of island and coastal nation sovereign borrowers to climate-related events such as natural disasters, as well as to mitigate subsequent credit rating downgrades and economic turbulence.

This is particularly important for islands that depend heavily on tourism for their national

economy, with the IMF recommending earlier this year that authorities should develop a comprehensive disaster resilience strategy that includes insurance. The solution was underwritten by Munich Re to allow Belize to refinance its sovereign debt under The Nature Conservancy's Blue Bonds for Ocean Conservation programme. For the US$364 million transaction, Willis Towers Watson created the innovative sovereign debt 'catastrophe wrapper' to provide insurance protection to cover Belize's loan payments following hurricane events.

As the need for climate risk to be integrated into mainstream sovereign loan programmes heightens, this transaction can be used as a template for integrated protection for creditors and issuers.

The design was led by Simon Young, senior director at Willis Towers Watson's Climate and Resilience Hub. He explains: "Volcanoes, earthquakes, and hurricanes repeatedly disrupt economic development in the Caribbean region, from households and communities to the sovereign level. That disruption leads to higher debt and a longer, more painful path to recovery.

"The parametric wrapper is a game changer for the financial resilience of island and coastal nations and will help to unlock the financing of nature-based solutions in achieving global net zero and biodiversity targets."

Michael Roth, public sector practice lead in Munich Re's capital partners team, adds: "Parametric insurance will be a powerful tool enabling borrowing countries hit by natural disasters to benefit from financial relief by a temporary waiving of debt service.

By reducing the credit risk for sovereign lenders, borrowing countries may improve access to, as well as terms and conditions of, debt finance." ■

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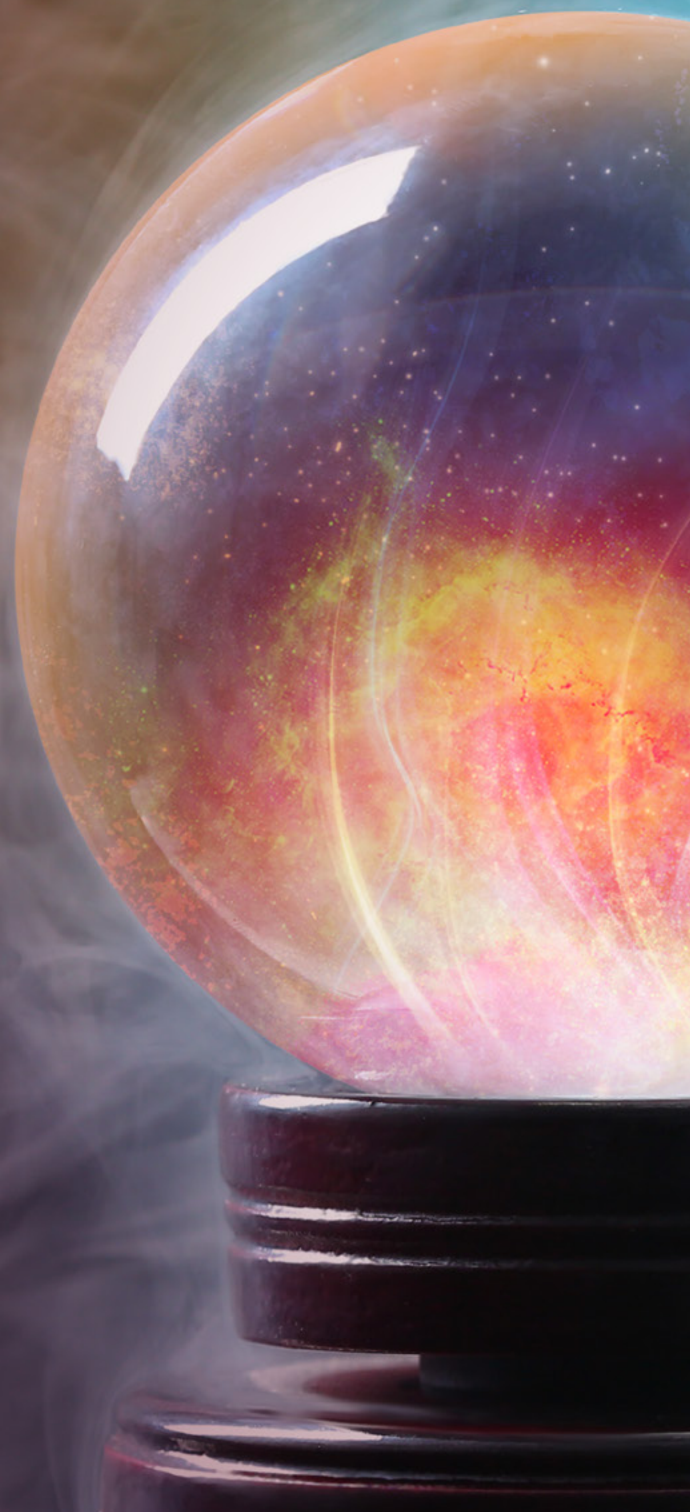
Looking into the crystal ball

As another year begins, Captive Insurance Times takes a look into the future to see what emerging risks, regulatory developments and challenges 2022 may bring

Rebecca Delaney reports



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If the emerging captive statistics for 2021 are anything to go by, the captive insurance industry looks set to continue its expansion and prosperity into the new year and beyond. Market conditions continue to be informed by the ongoing impact of the COVID-19 pandemic and the hardening commercial insurance market, providing a valuable opportunity for the captive industry to illustrate the advantages of captives as a long-term component of an organisation's risk management strategy.

Capitalising on the current market conditions to improve the reputation of captives and provide educational resources on the sector is critical to position captives as a significant branch of alternative risk financing.

A recent market segment report by A.M. Best identified that tougher renewals in Europe has led to a wider use of existing captives to optimise an organisation's risk transfer solutions, for example, increasing retentions or limits on existing coverage, or expanding into new lines of business. It is important for companies to exercise flexibility throughout insurance market cycles (particularly during hard cycles of increased rates and diminished commercial capacity), as well as hold access to reinsurance market capacity, the report notes.

Oliver Schofield, managing partner at Risk and Insurance Strategy Consultants (RISCS), explains: "Today's complex risks often are hard or impossible for the conventional market to insure, mainly for good reasons such as the newness of the risks, meaning underwriters have no data and no history on which to base their judgements."

Elsewhere, Aon's annual Captive Benchmarking Survey noted that despite the rate of increase in commercial insurance pricing beginning to flatten out in 2021, companies are continuing to investigate their alternative risk financing options as the difficulty in placing loss-hit lines persists.

Charles Winter, head of risk finance and chief operating officer at Aon Global Risk Consulting, explains: "Whilst some areas of the commercial market are showing signs of stabilisations, it is still more of a reduction in the pace of change rather than a reversal of the higher process or more restrictive terms."

He adds that this has an impact on captives, as higher commercial insurance prices strengthen the business case for a captive, providing appropriate premiums can be achieved for taking more risk.

Aon's survey also identified a trend of captive owners retaining more risk on a sustained basis while retaining an appropriate level of cover to address medium-term economic viability and price increases in primary markets.

"In the last half of 2021, there has been a definite increase in enquiries relating to pension buy outs including reinsurance to captives. This is from a low base but shows employee benefits generally being a more mainstream part of the captive agenda," Winter adds.

Looking at how these market conditions for the captive industry will develop in 2022, Debbie Walker, senior deputy commissioner at the North Carolina Department of Insurance, comments: "As with 2021, it is expected that the market conditions will be positive in 2022 for the formation and growth of captive insurance companies and their service providers."

Walker identifies that market conditions present "excellent opportunities for captive growth", particularly the hard commercial market, as this will allow the captive industry to assist insureds by offering to provide:

- Gap coverages
- Higher deductible reimbursement coverages
- Coverage for risks that cannot be insured throughout the commercial market
- Coverage for certain layers of risk
- Full replacement of commercial insurance at a reasonable cost

The opportunities currently available to the captive industry will foster mutual growth and development among service providers, including captive managers, auditors, actuaries, attorneys, and others, with Walker summarising: "Overall, the outlook for the captive industry in 2022 appears to be very favourable."

Schofield anticipates that in 2022, captives will continue to address this exposure gap for their parent companies, as well as increase their aggregate portfolio retentions and access to the captive reinsurance market for multi-year portfolio solutions to provide longer-term stability in risk management planning.

Emerging risks

Emerging risks continue to play a significant role in the formation and expansion of captives, as they are by default designed to provide cover for an 'unusual' or 'extraordinary' risk to address current risk-related challenges.

Regardless of the type of emerging risk, it is fundamental for a captive to perform feasibility studies and risk evaluations, as well as exercise adaptability and seek quotes from the commercial marketplace if they select to transfer the risks.

"A benefit of utilising a captive insurance company is the ability for the insured to obtain the coverage needed with the terms and conditions that apply specifically to that insured's situation."

"It is expected that in 2022 insureds will continue to evaluate the risks they are or will be facing, and upon that evaluation seek coverages from their captive insurers to address those risks," Walker affirms.

In the annual survey by the Association of Insurance and Risk Managers in Industry and Commerce (Airmic), it was found that risks associated with the COVID-19 pandemic have significantly shaped the global risk profile in terms of risk management, crisis management and business continuity planning, owing to greater risk connectivity.

The survey found that the top three front-of-mind risks — business interruption following a cyber event, loss of reputational value, and failure of operational resilience — remain the same from 2020 in the ongoing context of an accelerated shift to a virtual economy, indicating that these risks may continue to emerge in 2022.

Specifically, ESG was identified as a key 'hot topic', with more than 40 per cent of surveyed risk professionals believing that climate change and transition risks will have a material impact on their organisations within the next one or two years.

The survey noted that insurance and risk management professionals and organisations are actively reviewing and updating their strategic approach to resilience in order to better address challenges arising from systemic crises, a trend which is set to continue into 2022.

Winter explains: “Longer-term, we are seeing companies in carbon-intensive industries look to captives and mutuals as the commercial market withdraws from providing coverage. There is time to plan whilst cover is still available but the direction of travel seems one way so those that do not consider the options risk future issues.”

The second ‘hot topic’ emerging risk identified in Airmic’s survey was cyber. Winter explains that the commercial insurance market is significantly failing to meet the requirements of premium rates, scope of cover and capacity for cyber risk.

“It is now rare to have a discussion involving captives without cyber being top of the list of issues for large commercial buyers. Captives are looking to take what would have been the entirety of primary layers as insurers retreat from risk or to provide a parallel tower buying back lost cover,” he notes.

Airmic’s pulse survey found that cyber risks are the most likely new risks to be financed by captives in order to address these coverage gaps, particularly as the COVID-19 pandemic accelerated the implementation of digital transformation programmes and the trends associated with cyber risks. This was affirmed by Aon’s 2021 Global Risk Management Survey, which ranked cyber as the number one risk globally across each surveyed region, industry and respondent type owing to the COVID-19 pandemic, which has highlighted the increasing importance of an organisation’s ability to manage long-tail risks.

Although Airmic observed ‘green shoots’ in the easing back of premium rate increases and cover limitations, as well as progress in cyber risk profiling, the cyber insurance market is likely to experience further disruption in 2022 as issues surrounding programme capacity continue into the new year.

RISCS’ Schofield says: “We expect captives to play a larger role in certain coverages such as cyber where capacity and premiums are challenged, as well as provide industry solutions to groups of businesses in the same industry group facing the same coverage challenges. We are actively working on three such projects right now in the energy, construction and professional services space, all of which will come to fruition in 2022.”

“It is now rare to have a discussion involving captives without cyber being top of the list of issues for large commercial buyers. Captives are looking to take what would have been the entirety of primary layers as insurers retreat from risk or to provide a parallel tower buying back lost cover”

North Carolina’s Walker names business interruption as another significant emerging risk arising from the pandemic: “With the continuing threat of COVID-19, it is anticipated that captives will provide coverage to their insureds to address the impact of the pandemic, such as business interruptions.”

She adds other risks that captives may seek to address in 2022 as the effects of the pandemic continue include supply chain disruption, talent acquisition and retention, corporate governance risk management (including directors and officers liability), and the risk that new innovations will disrupt or make a business product or service obsolete.

Challenges on the horizon

Despite 2021 presenting many opportunities for the captive industry, insurance and risk managers enter the new year with lingering challenges.

The increasingly significant role of risk management teams within firms requires efficient internal communication between these teams and the C-suite to keep the latter aware of their risk exposure, reduced market capacity and the financial impact of increased risk retention during a hard market.

"As the captive industry continues to grow, one of the biggest challenges will be ensuring that the traditional insurance market supports captives in playing a larger role in their own risk retention"

Schofield notes: "As the captive industry continues to grow, one of the biggest challenges will be ensuring that the traditional insurance market supports captives in playing a larger role in their own risk retention and will actively work with their clients rather than against their clients, which sadly we have seen too often in 2021."

Winter adds that uncertainty around the future direction of the market creates challenges in decision-making and planning processes, as potential new captive owners are unable to accurately assess the real value it will bring to their organisation.

"The general trend of a raising of the barriers to entry in terms of premium tax rises and more rigorous application of national regulations continue to require close scrutiny to achieve the desired result," he identifies.

In a PwC survey in which insurers and reinsurers rated industry risks facing the global insurance industry, cybercrime was ranked as the top risk over the next two to three years, as the remote working model has highlighted the vulnerability of firms to cyber risk.

In addition, the evolving type, volume and success of cyber threats has heightened cyber to both an operating and underwriting risk, as attacks can cause losses related to business interruption, as well as operational issues from the loss or corruption of data and reputational damage.

Cybercrime was followed by regulatory risk, as insurers indicated the belief that regulation has become excessive, onerous and bureaucratic to the extent that it may be a hindrance to business operations. Technology was also identified as a challenge to the insurance industry, with concerns around the ability of the industry to keep up with technological modernisation.

Other named concerns in the survey include interest rates, change management, competition, investment performance, macronomy and human talent. The latter is particularly relevant to the captive industry, with Walker noting that "a major challenge [in 2022] will be the recruitment and retention of personnel".

She explains: "Prior to the COVID-19 pandemic, the industry was already facing challenges in the hiring of qualified employees, the recruitment of younger talent and the retirement of seasoned professionals."

"Now the industry faces those same challenges, but in addition potential workers desire more flexibility, remote work opportunities, and a better work-life balance."

"The insurance industry has been slower than some others to respond and provide a more flexible work environment. Going into 2022, the captive industry will need to make the industry appealing to the workforce by providing flexible benefits in order to recruit new workers and to retain staff," Walker recommends.

Regulation

For the European captive industry, the ongoing Solvency II review promises a more reconciled implementation of the proportionality principle by EU member states, which is intended to "ensure that the practices and powers of supervisory authorities are proportionate to the nature, scale and complexity of risk inherent in the business of the insurer or reinsurer".

This is especially relevant to captives as it ensures that regulatory requirements do not become so burdensome that they are an impediment to a captive company's business operations.

In September 2021, the European Commission adopted its review package for Solvency II requirements, the capital changes of which Fitch Ratings believes will benefit the European insurance sector's burgeoning interest in ESG investments. In 2022, the European Parliament and member states of the European Council will negotiate the final legislative texts based on the Commission's proposals.

Elsewhere on the regulatory horizon for captives, International Financial Reporting Standard (IFRS) 17 is set to take effect on 1 January 2023, which Aon's Winter describes as "the largest change on the immediate horizon".

Issued by the International Accounting Standards Board, the new standard is designed to consolidate the way in which insurance companies (including captives) value and report on insurance contracts to promote greater transparency.

Late last year, Marsh recommended that captives be mindful of four specific areas that will be affected by the implementation of IFRS 17: contract boundaries and underlying clauses (such as a termination clause or re-underwriting clause); probability-weighted future cash flows of an insurance contract; entity-specific calculations of risk adjustment, risk appetite and compensation; and the contractual service margin.

Winter warns: "Given the nature of many captives' portfolios, the changes may not be as pronounced as some other parts of the industry but there will be challenges for captives writing longer-term programmes and they will need to watch out for a mismatch in the accounting for the underlying risk assumed and the protection offered by reinsurance."

He adds that it will be "interesting if the post-Brexit opportunities that the UK has will lead to any more favourable regulations for captives, particularly due to the trend towards locating closer to home that is seen in a number of geographies".

Looking elsewhere in the global captive industry, Schofield anticipates that in the continued hardening market, more jurisdictions will follow Bermuda, Guernsey and Labuan to enable fast-track legislation for cell captives.

"The states that desire to grow their captive industry will continue to develop their captive regulatory programmes by improving or updating their captive insurance laws and finding other ways to stand out from other captive domiciles"

"There has been talk of captives redomiciling to the location of the parent and we will be keeping a watchful eye on that in 2022," he adds.

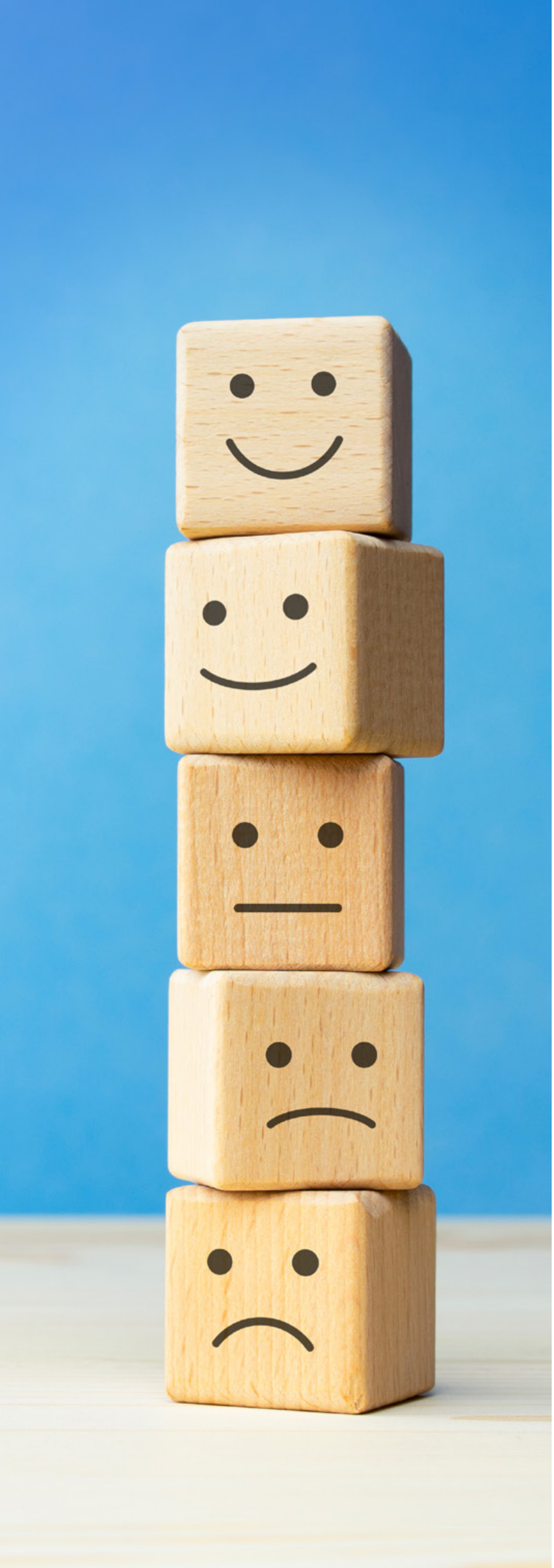
From a US state regulatory perspective, Walker notes that the regulatory environment is on the whole welcoming of the industry in states with captive-enabling legislation.

"The states that desire to grow their captive industry will continue to develop their captive regulatory programmes by improving or updating their captive insurance laws and finding other ways to stand out from other captive domiciles in order to meet the evolving risk management needs of business owners," she concludes. ■

Stake your reputation

Nir Kossovsky, Denise Williamee and Peter Gerken of Steel City Re discuss the development of reputational risk, including current trends, how a captive can provide cover, and the specific challenges in insuring this risk

Rebecca Delaney reports



Reputational risk management has evolved to a heightened importance in recent years owing to the advance of behavioural economics, which allows the financial services sector to more effectively quantify concepts such as behaviour, psychology, value and communications.

Peter Gerken, senior vice president, risk transfer agency and insurance, Steel City Re, describes reputational risk as “the threat of lost corporate value when emotionally-charged stakeholders abruptly cease anticipating a promised or positive future experience, benefit or performance”.

Gerken adds that this is a different type of risk compared to cyber, product recall or employment practices liability, for example, because it both weakens a company’s growth strategy and exposes the board of directors to scrutiny from regulators, litigators and social media.

Greater recognition of the non-physical damage sustained by behavioural economic perils has stemmed from social politics and social justice movements for companies to adhere to more ethical standards, particularly in the oil and fast fashion industries.

“Cultural friction enhanced by social media, including #MeToo and #BlackLivesMatter, diversity, equity and inclusion, environmental activism and social inflation, gave tangible proof that reputation is more than publicity,” notes Nir Kossovsky, CEO, Steel City Re.

A report by Willis Towers Watson, ‘Reputational crisis insurance for the retail industry’, found that recent years have seen systemic changes to the way in which ordinary people consume information and form opinions. The new reputational landscape is also informed by changing demographics, declining public trust, state and non-state manipulation of media, and changes to the quality and quantity of data, the report notes.

Similarly, a joint report by Aon and Pentland Analytics investigating reputational risk in the cyber age determined that the risk landscape is “fundamentally shifting as the digital and physical worlds continue to connect and converge”, particularly owing to the rising power of social media, which has enabled people with the environment and means to collect and circulate information (and misinformation) globally and instantly. As well as negative social media, reputational risk events can derive from product failure, cyberattacks, supply chain disruption and executive misconduct.

> *“Cultural friction enhanced by social media, including #MeToo and #BlackLivesMatter, diversity, equity and inclusion, environmental activism and social inflation gave tangible proof that reputation is more than publicity”*

Amid this environment, Aon’s 2021 Global Risk Management Survey ranked reputational risk fifth (compared to second in 2019 and first in 2017), with environmental, social and corporate governance (ESG) as a particular driver of reputational damage. Denise Williamee, vice president, corporate services, Steel City Re, describes ESG issues as “the dominant source of reputation risk”.

The survey notes that reputational risk is ranked higher in North America (owing to a higher number of corporate reputational crises, such as financial fraud, neglect of employee health and inappropriate advertising) and in the public sector (owing to governments’ poor handling of the COVID-19 pandemic, political scandals and extreme partisan politics).

In particular, the COVID-19 pandemic has developed the idea of conceptual value among governance, legal and risk professionals, and how best to protect it through insurance and risk management strategies.

Therefore, it is crucial for companies to reconsider their existing risk management, assessment and financing programmes, as well as to invest in a form of reputational crisis insurance, as this provides real-time reputational intelligence, profit protection, crisis communications and brand reconstruction based on perceptions of transparency, honesty and social responsibility.

Willis Towers Watson’s 2021 Global Reputational Risk Management Survey Report highlights reputation as a compound risk that should be addressed as a company-wide strategic issue rather than the sole responsibility of risk management teams, with 79.5 per cent of survey respondents indicating a belief that the focus on reputational risk in their business will only increase over the next five years.

Steel City Re’s Denise Williamee observes that organisations are accepting that reputational risk governance is becoming “mission-critical”, with many taking the following measures:

- Increasingly relying on the chief legal officer to oversee its management
- Establishing an enterprise-wide reputation leadership team of stakeholder owners to staff a standing ‘combat information centre’
- Insuring the risk with captives and reinsurance
- Signalling the value of all above to proxy advisors, bond raters and institutional investors

Using captives for reputational risk

As organisations explore innovative reputational risk insurance products that encompass media monitoring, benchmarking, big data tools, stakeholder surveys and management platforms, this greater demand for integrated risk management and governance solutions has seen alternative capital sources enter the reputational risk reinsurance market — including captives. Captives hold a significant strategic role in reputational risk management by dually creating a financial solution for reputational risk and an ‘arms length’ risk management practice to protect the value of the parent company’s reputation.

Kossovsky explains: “Captives are invaluable. They can tactically cover the costs of going-forward impaired cash flow — analogous to an umbrella or difference in conditions policy — and cover the basis risk inherent in commercial parametric reputation and ESG insurance policies."

Captives simplify the conceptual value of ESG within the operational and governance systems that help companies mitigate risks to address their stakeholders' ESG expectations by providing evidence of reliable measures of quantification — and use of a captive demonstrates that due diligence by a third-party has authenticated the company's reputational risk management.

Gerken adds that this tactical coverage strategically indicates implementation of prudential risk management to the capital markets and other stakeholders. "No commercial solutions currently in play can offer this vital spectrum of both tactical and strategic protection. Just as directors and officers insurance discovered widespread need in the early 1980s when dutiful boards were sued for stock price drops, no company today can afford to proceed without a reputation/ESG solution, and captives should have a prominent role," he notes.

"No company today can afford to proceed without a reputation/ESG solution, and captives should have a prominent role"

Challenges in insuring reputational risk

The complexity of quantifying the intangible value associated with reputational risk naturally presents challenges in its measurement, management and monitoring.

Respondents in Willis Towers Watson's 2021 Global Reputational Risk Management Survey indicated that major complications are a lack of clear methodology (59.5 per cent) and a lack of access to reliable data (51 per cent). Other named challenges include inadequate company tools and insufficient skills among current staff.

There exists further potential issues in implementing captives to cover reputational risk. For example, there is legacy organisational resistance within the captive industry to the notion of insuring and managing reputational risk because of the misconception that it is all about marketing, communications and public relations rather than genuine, or traditional, risk management.

In addition, there is a legacy organisational belief that reputational risk can be mitigated through traditional legal strategies — in fact, it is difficult to perform value-at-risk quantification outside of a parametric model.

However, Kossovsky remains confident that "a company with an astute board, risk-aware leadership and sophisticated risk management team will find placing reputation risk in a captive with a parametric policy straightforward within many receptive jurisdictions".

Williamee points to Connecticut as a key example, where the insurance department recently wrote it "does not anticipate any issue for prospective captives to be domiciled in Connecticut to utilise Steel City Re's behavioural economic underwriting, parametric policy and pricing services to insure reputation and ESG-related risk".

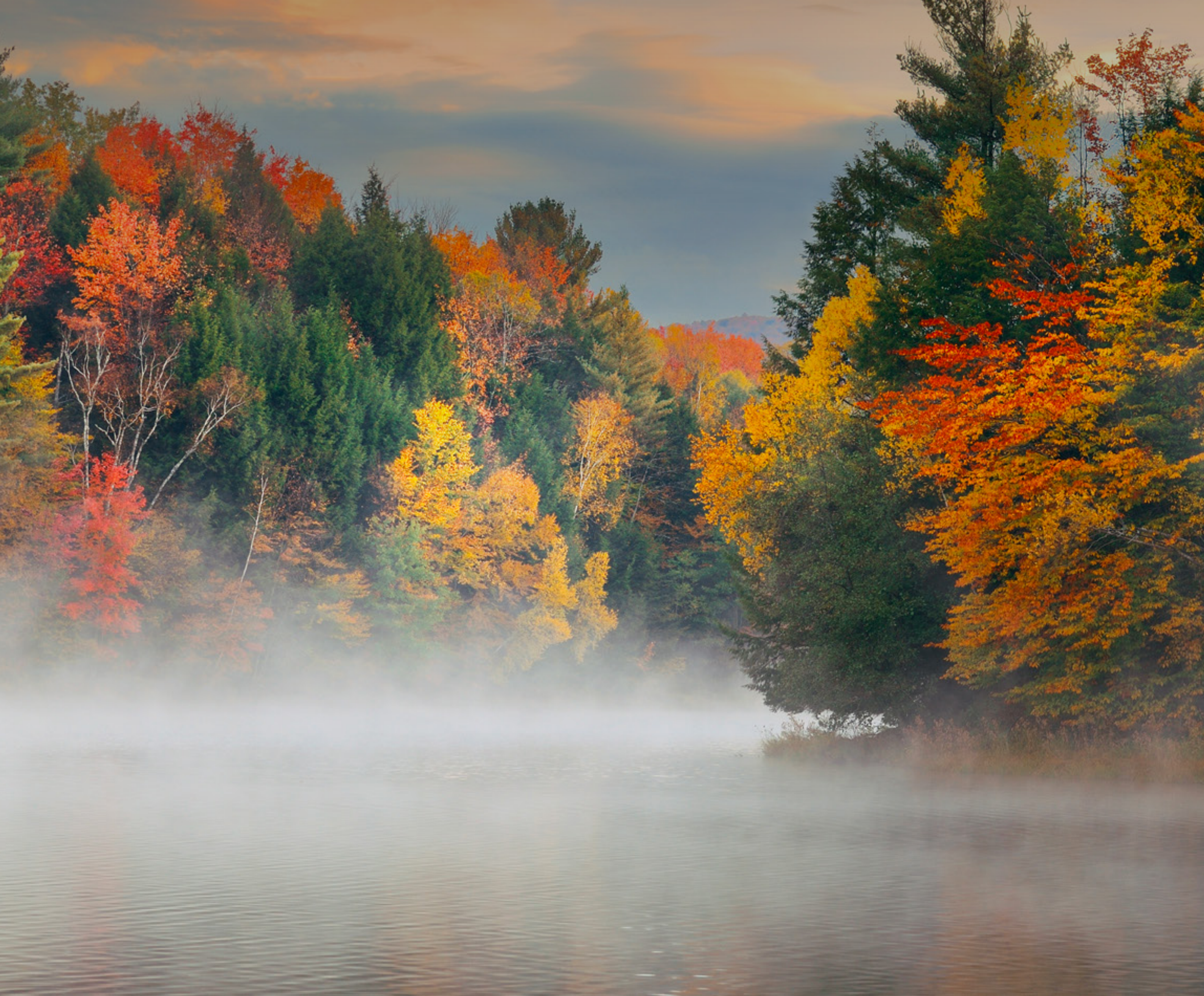
Looking ahead, the evolution of the reputational risk landscape is certainly set to be interesting, with Gerken anticipating that all external environmental forces and social pressures that have impacted the frequency, severity and perilousness of reputational risk over the last 12 months will only increase and compound owing to the industry-wide focus on ESG.

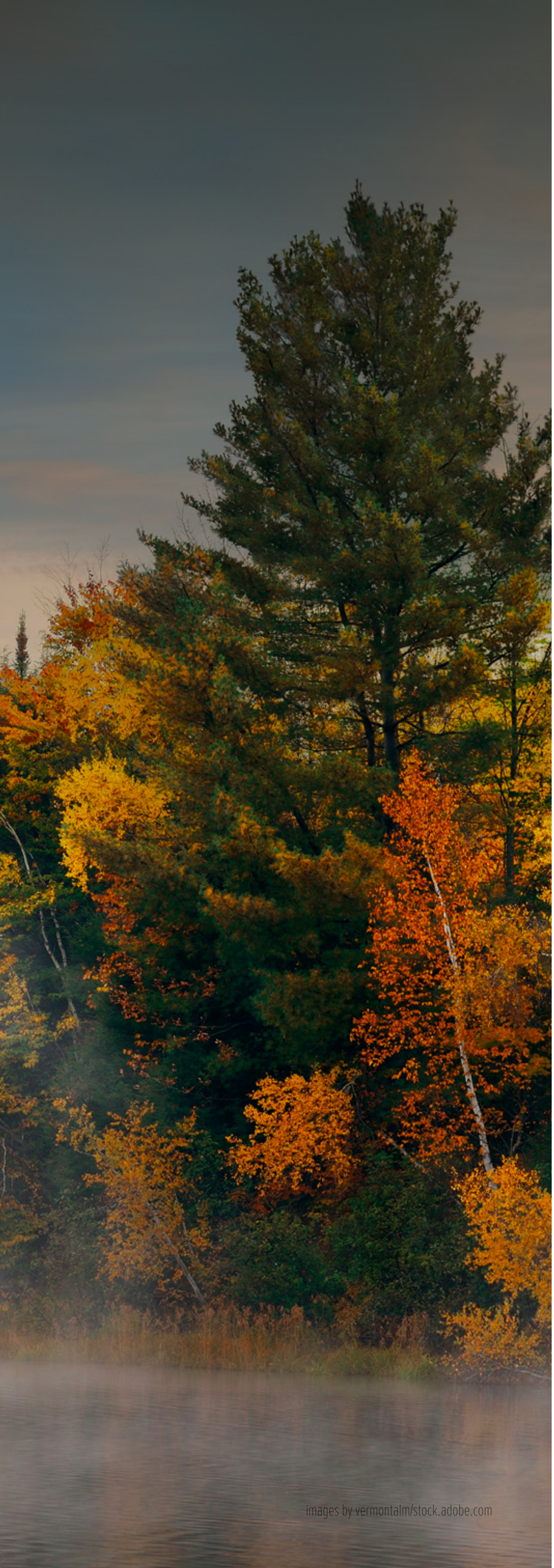
"Boards must demand and implement upgrades to their firms' enterprise reputation risk management apparatus or face the risk of being discounted by the capital markets and the subsequent ire of disappointed investors," Kossovsky concludes. ■

Sitting on a gold mine

Following the year in which Vermont celebrated its 40th anniversary as a 'gold standard' captive domicile, Brittany Nevins reflects on trends in the Green Mountain State's captive industry, regulatory developments and emerging risks

Rebecca Delaney reports





What trends did you observe in the Vermont captive market in 2021? How do you assess the landscape going into 2022?

We have observed a few trends this year. One trend the broader captive insurance industry is seeing is a high number of new captive formations, and certainly Vermont has seen that this year. The regulatory team has been very busy with wrapping up the new formations by year end, with 45 new captive formations to date, up from 38 last year — and already there is a high number of captives that plan to license at the start of the new year. 2021 is our fourth highest year for captive formations out of our entire 40-year history. Additionally, few captives have dissolved this year compared to years past. At year end in 2020, we had 589 captives and currently we have 625 captives licensed in Vermont.

We are continuing to see new captive formations from every industry and many different types of captives, but we are seeing more formations of agency and cell captive types especially. Nine of the 45 new companies formed this year were sponsored cell companies, two of which were formed by agencies.

We have also approved agency-styled cells within existing sponsored cell companies. There are a few likely reasons for this. In 2017, the Vermont legislature passed a bill to add agency captives and we are now seeing the results of that legislation. Another reason is the hard insurance market that continued through 2021. For the cell formations, many companies are realising the opportunity and flexibility the cell structure provides for their company.

Going into 2022, there continues to be tremendous interest in captives as an alternative risk management tool. We have a great foundation for success that we will continue to build on into next year. The slowdown of captives dissolving will likely continue well into the future as well.

What were the most significant challenges facing the captive market in 2021? How do you see these challenges evolving into 2022?

Staffing for all aspects of the insurance industry has been a challenge for some time, and the COVID-19 pandemic did not help! Captive insurance continues to be an industry that few have heard of and consider as a career option. While this challenge will not go away in

2022, there are many efforts being made to raise awareness about the captive industry as a career choice. In Vermont we plan to release an informational video about working in the captive industry, as well as planning to launch a career webpage with information and resources available to those interested in working in the industry. I also plan to make targeted efforts to speak with students in a variety of fields about the benefits of this niche industry. This is just the start of a long-term plan to grow the captive industry workforce.

Taxation of captives by non-domicile states is a complex issue that will likely have an impact on captives wherever they are domiciled. There could be significant variability in taxation among non-regulatory states that could make it more challenging for captives to form and sustain themselves.

Are there any regulatory developments in the pipeline for Vermont in 2022?

Nearly every year over the last 40 years Vermont has passed a captive bill. It is considered a tradition as we know that there is always room for improvement, no matter how small. We feel it is important to modernise our statutes every year to keep pace with the captive industry and improve our regulatory processes. The captive bill is put forth as a collaborative effort by the Vermont Captive Insurance Association and the Vermont Department of Financial Regulation (DFR). This year is no different, and we have identified a few areas for minor improvement and clarity. We want to be sure the law accurately reflects the DFR's preferred practices and expectations of companies to prevent confusion or misunderstandings around statutory language.

Additionally, we are working on specific language in the upcoming captive bill in 2022 to allow for captives to utilise parametric risk contracts as an additional risk management tool. Although parametric risk is not considered insurance, parametric risk contracts are becoming commonplace as another form of financial protection for catastrophic events, and we want to support captives in accessing this tool.

How do you expect emerging risks to continue to unfold in 2022?

Cyber and climate change continue to be emerging risks in 2022. Cyber attacks and climate-related storms have become more frequent and severe over time — and they are not risks that will go away anytime soon. These risks are intimately connected with public policy, the influence of which can have significant impacts on the insurance industry and the way these risks are understood and quantified. Discussions around ESG in the captive industry seem to be increasing as a result of the increased interest in the emerging risk of climate change. Additionally, the use of parametric risk contracts have become more of a tool utilised by captives to address the emerging risk of climate change. It is not clear how these risks will continue to unfold, but they certainly will not be going away in 2022.

What is top of the department's development agenda for 2022?

It would be simple in years of success to give ourselves a perfect score and be closed to the possibility of improvement, but we find that in years of success and when times are busy, we can more easily identify issue areas in our internal processes. Within the DFR there have been fruitful discussions internally around areas for improvement.

Changes in internal procedures are underway, a need to hire more staff has been identified, and there is an effort to improve communications with companies to ensure an even more efficient process and clear expectations. We always want to constantly be improving in times of challenge and success, which is part of what makes Vermont unique as a domicile. ■

Brittany Nevins
Captive insurance economic development director
State of Vermont

Marsh has appointed Matthew Latham as alternative risk transfer leader.

In his new role, Latham will work within Marsh UK's financial solutions group, where he will be responsible for advising clients on structured reinsurance, legacy transactions, parametric coverage, and other customised, innovative insurance solutions.

Latham previously served as chief underwriting officer for global programmes and captives at AXA XL, a role he held since August 2020, before which he was head of global programmes and captives at the insurance subsidiary.

Before this, Latham held the positions of head of client management UK, Solvency II business leader, and vice president of risk finance at AIG, where he led a senior team of relationship managers, implemented changes to the European operating model's governance processes and capital management, and underwrote alternative solutions for major corporate clients and their captives, respectively. ■

Helmsman Management Services has appointed Ryan Burke as senior account executive.

In his new role, Burke will be responsible for leading the growth of the third-party administrator's group captives programme and carrier business.

Burke previously held the position of senior national account executive at Davies Group, where he was responsible for the programme design of captives, risk retention groups (RRGs), carrier programmes, loss portfolio transfers, run-off/legacy programmes, and high deductible programmes.

Before this, he served as account executive at Assurance, a Marsh & McLennan Agency company, and Pearl Insurance, where he had a particular focus on programmes and RRGs.

Willis Towers Watson has named Ed Koral as director of strategic risk consulting.

In his new role, Koral will be responsible for delivering analytics to clients' risk management and insurance programmes, as well as improving the outcomes of these programmes.

Koral previously served as managing director at BDO, where he was responsible for expanding BDO's insurance and risk management consulting capabilities, particularly for captives, self-insurance, insurance vendor and sourcing management.

Before that, he was specialist leader at Deloitte Consulting's risk management consulting practice, where he administered insurance services to non-insurance organisations, including captives, alternative risk financing, and other insurance product offering strategies. Koral also served as a board member at the Vermont Captive Insurance Association between 2011 and 2017.

Commenting on his new role via LinkedIn, Koral says: "I am excited to be joining the strategic risk consulting group at Willis Towers Watson, delivering world-class analytics and dedicated to improving client outcomes."

BevCap Management has appointed Joshua Lees as director of consulting.

The risk programme management firm specialises in alternative risk for business professionals in the lines of commercial auto, general liability, workers' compensation and employee benefits.

BevCap Captive Group is a homogeneous group captive insurance company designed for the needs and exposures of the beverage distribution industry, such as long-term pricing control, potential for reduced costs, buying powers, broader distribution of risk, and enhanced loss control, risk management and claims services.

In his new role, Lees will work with BevCap's producers and account managers on clients' risk management consulting needs, as well as lead strategy on complex placements for existing clients and new business opportunities. Lees brings with him extensive experience in property and casualty underwriting and customer stewardship, having previously served as managing director and middle-market business development director in the construction, technology, oil and gas, marine and public sectors at Travelers

CICA names new board member

The Captive Insurance Companies Association (CICA) has appointed Prabal Lakhanpal to the board of directors, effective March 2022.

Lakhanpal currently serves as vice president of Spring Consulting Group, an employee benefits and risk management consultancy providing enterprise risk management and risk funding solutions, including single-parent captives, group captives, micro captives, risk retention groups and voluntary employee beneficiary associations.

He also chairs CICA's NEXTGen young and new professionals committee, which aims to promote and develop the next generation of captive insurance professionals.

Commenting on the appointment, CICA president Dan Towle explains: "The captive industry is growing and changing rapidly."

"As a result, what the industry needs and what today's young professionals want is evolving. It is important for CICA to hear the perspectives of our young professionals because they are our future."

Lance Abbott, CEO of BevCap Management and CICA board chair, says: "Having the NEXTGen chair on the board has helped us to make sure we are incorporating strategies that support career development and are appealing to young professionals when we are creating conference content and other programmes."

Lakhanpal adds: "I am thrilled to be joining the CICA board and to work with CICA and its stakeholders to help advance the captive industry."

"I am grateful for the opportunity and appreciative of CICA's commitment to developing the next generation of captive professionals and leaders.". ■

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