Communications, Media, and Technology Practice UK & Ireland

DRIVING VALUE AND REDUCING RISK THROUGH CAPTIVE INSURANCE SOLUTIONS

SOLUTIONS…DEFINED, DESIGNED, AND DELIVERED.

CONTENTS

A CHANGING RISK LANDSCAPE

CAN TRADITIONAL RISK TRANSFER MODELS MEET TODAY'S DEMANDS?

In the ever-changing risk landscape for communications, media, and technology (CMT) companies, the need to accurately mitigate risks and protect business has never been greater. However, what are the risks which CMT companies face today? Can traditional risk transfer models meet today's demands? As industry sectors driving the economies of tomorrow and facing some unique risk issues, why are CMT companies looking to captives[1] and what role can they play as risk incubators? This paper looks at the alternative risk transfer (ART[2]) vehicles that are being used by some CMT companies as part of their overall risk financing strategies and how these solutions can play an active risk management role.

UNIQUE AND COMPLEX RISKS

CMT companies are innovators of new technology, changing and disrupting entire industries across the board. The nature of these business models presents new disruptive risks which require effective mitigation. The use of captives and other ART vehicles can provide significant value in working to address these risks.

- **Changing Risk Landscape:** Home to many start-up organisations and innovative companies, the CMT industry faces disruptive risks unique to the sector. Many of these companies are on the forefront of esoteric risks, which are typically significant challenges for the traditional insurance market.
- **Lack of Commercial Insurance Appetite:** Many CMT companies find that effective risk transfer in the commercial insurance market cannot be obtained for key emerging risks. Traditional insurance can struggle to offer the full scope and extent of solutions required.
- **Cyber Terrorism:** CMT industries are particularly sensitive to the rise of cyber terrorism. Many organisations struggle to secure adequate coverage for physical property damage bodily and injury as a result of a cyber-type incident; this is mainly due to the structural limitations of the insurance market. Other challenging risk categories include intellectual property (IP) infringement, supply chain, non-damage business interruption, product recall, and technology errors and omissions.

Key Concepts:

1. **Captive:** Where an organisation creates its own licensed insurance company to provide insurance for itself.
2. **Alternative Risk Transfer:** Methods of providing protection for risks organisations face other than traditional insurance or (re)insurance.

RISK SPOTLIGHT – INTELLECTUAL PROPERTY

COMPANIES MAY BE OVERLOOKING RISK TRANSFER OPTIONS FOR ONE OF THEIR MOST VALUABLE ASSETS

In Marsh's 2017 CMT Risk Study, respondents showed little confidence in their ability to mitigate intellectual (IP) risk through either risk management strategy or specific insurance coverage. IP was ranked third on the list of risks, yet only 27% of CMT professionals say they have largely or completely mitigated it.

74% of survey respondents do not buy IP insurance. Common reasons for not buying IP insurance included that the risk is too difficult to quantify, the coverage is too expensive, and the available insurance does not provide enough coverage.

INTELLECTUAL PROPERTY RISK DEEMED TOO DIFFICULT TO QUANTIFY; CONCERNS WITH AVAILABLE COVERAGE

Despite the reasons for not buying IP coverage, CMT companies need to address the risk. In 2014 alone, circa US$3 billion was spent on patent litigation.

Should this be a risk category where captives and ART arrangements can play an important role?

AMONG CMT RISK PROFESSIONALS:

65%

RANKED INTELLECTUAL PROPERTY AS A HIGH CONCERN — THIRD HIGHEST RANKING OVERALL

26%

OF COMPANIES BUY STANDALONE IP INSURANCE OR HAVE OTHER COVERAGE FOR THE RISK

Source: Marsh's 2017 CMT Risk Study

CREATING SECURITY IN UNCERTAINTY

WHY FORM A CAPTIVE?

According to Marsh's 2016 Captive Solutions Benchmarking Report, the most popular reason to form a captive was to provide a formal regulated vehicle to fund corporate retained risk and the ability to obtain commercial (re)insurance on a direct basis. This aids CMT companies, who often struggle with capacity, to operate higher retentions and to have direct access to higher limits in the (re)insurance market, but also provides an effective risk model to own, manage, and more efficiently transfer risk.

WHICH RISK FINANCING VEHICLE FITS BEST?

The majority (84%) of CMT organisations included in the benchmarking report use the single parent structure. A single parent captive is its own entity, with 100% control of both decision making and operational management, which allows organisations the flexibility to have full say in matters ranging from investment policy to engaging service providers. Catastrophic (CAT) bond, insurance-linked securities (ILS), and other non-traditional strategies have also allowed organisations to expand their risk management programmes in new and innovative ways.

Large public companies comprise the majority of CMT captives. Over the past few years, some of the largest economic advantages identified were for our clients in the CMT industry.

DOES CAPTIVE SIZE MATTER?

Traditionally, the captive domain has been dominated by extra-large captives classed as those generating more than US$20 million in premium each year. However, currently close to 35% of the captives benchmarked in the 2016 report are categorised as small (annual premiums less than US$1.2 million).

"For many CMT companies, the use of a captive as a primary risk management tool is an essential component in enabling an effective risk financing strategy. Risk incubation strategies are also enabling companies to begin to more effectively mitigate their challenging esoteric risks, particularly those where traditional insurance may not be able to play an effective role."

SAM TILTMAN
SENIOR VICE PRESIDENT
MARSH'S CMT INDUSTRY PRACTICE

SPOTLIGHT

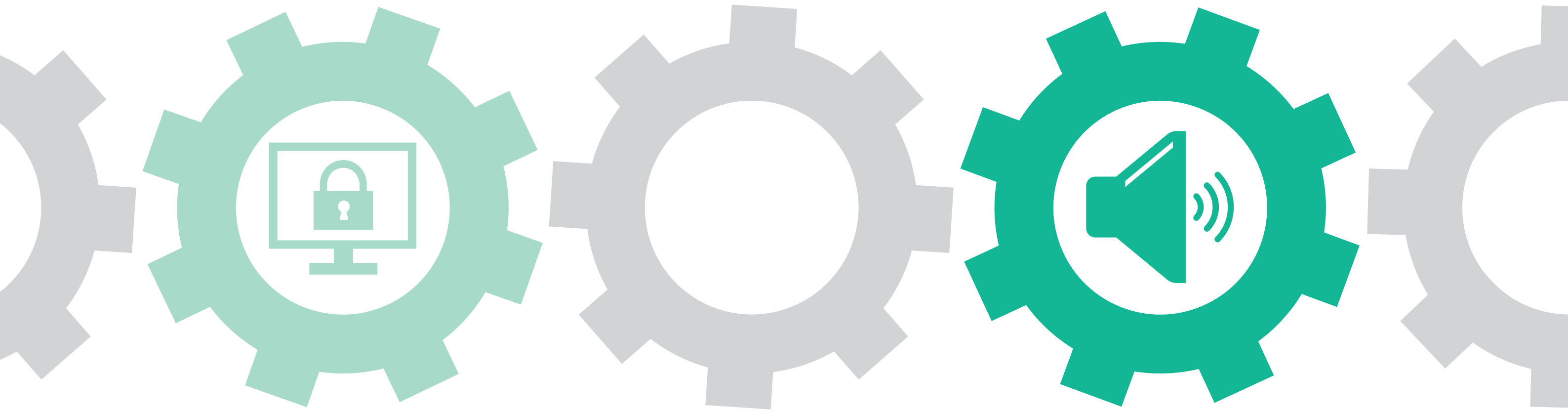
Small captives offer companies many benefits, including funding for catastrophic losses, insuring risks that are cost prohibitive to transfer, and a "start small" philosophy with the intention of growing capital and surplus over time. Small captives can also be used as "risk incubators" to develop an underwriting history before transferring risk to the commercial insurance market. We expect continued growth in small captive formation in the coming years.

CYBER

Organisations have a significant obligation to protect the privacy and personal data of their employees and customers. Cyber terrorism is the single most likely attack and most impactful risk globally and will undoubtedly continue to threaten all businesses.

Captives are one of the most effective ways to finance cyber risk. Cyber programmes initiated by captive owners grew by 30% in 2015, and in the past four years the amount of captives writing cyber has increased 160%. Organisations can use captives to access the reinsurance market in order to obtain higher limits and lower premiums as gaps in coverage continue to emerge.

By using captives as a mechanism to insure the gaps in traditional insurance coverage, organisations can reduce their risk of extreme financial harm, have the ability to mitigate reputational damage, and cover costs associated with class-action lawsuits should a cyber-attack occur.



WORKPLACE DISRUPTION

Widening income inequality, rising cyber dependence, an ageing workforce, and higher than normal unemployment rates all contribute to the risk landscapes facing today's organisations.

The fourth industrial revolution, the rapid digitisation of the workplace, is having some adverse consequences. Organisations are rapidly eliminating jobs based on the efficiencies which technology can provide. Computers now complete tasks once reserved for humans; entire industries are being eradicated based on concepts being developed like artificial intelligence. CMT companies are at the forefront of this disruption.

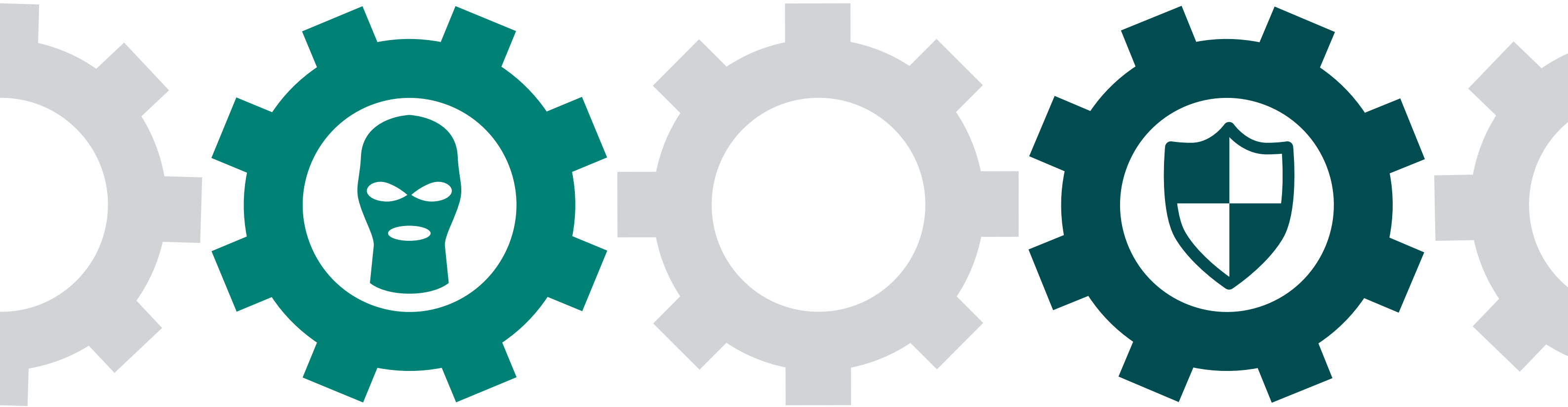
It is important for organisations to incorporate non-traditional coverages such as business interruption and cyber into their captive. It is also prudent to consider ways to incorporate employee benefits into a captive, which can help a business with the strains of a changing workforce and also help to balance the overall risk portfolio underwritten by the captive, such as utilisation of negatively correlating risks.

TERRORISM AND GLOBAL TERRORISM POOLS

The changing international security landscape has led to violent attacks by groups with religious or political goals in all parts of the world.

UK CMT companies are able to use captives to access the UK government's terrorism programme — Pool Re, either to issue policies to perils typically excluded from conventional terrorism policies, such as nuclear, biological, chemical, radiological (NBCR), or as a mechanism to reinsure their terrorism exposure. By reinsuring terrorism exposures, CMT companies may be able to achieve cost reductions as market first loss limits are given and they are able to elect to insure only part of their asset base; in contrast to Pool Re which requires all assets to be insured.

CMT companies don't need a captive to provide an alternative to Pool Re. However, when captives are used as a front, terrorism insurers — who are sometimes members of Pool Re themselves, can also write UK terrorism which allows for much larger limits to be purchased.



POLITICAL AND SOCIETAL RISK

Political risk exposures for international corporations are on the rise, as we see more companies doing more business in the Middle East, North Africa, and Latin America. Increased social unrest, political instability, regime collapses, and territorial disputes are amongst some of the risks hindering parent companies' ability to conduct business.

By writing political risk coverage into captives, businesses have the ability to gain protection from the threats resulting from interaction with international emerging markets. Captives can write multiyear contracts, with customised terms and conditions, and obtain further reinsurance protection.

US$4.9 BILLION OF CAPTIVE PREMIUM MANAGED BY MARSH FOR CMT COMPANIES

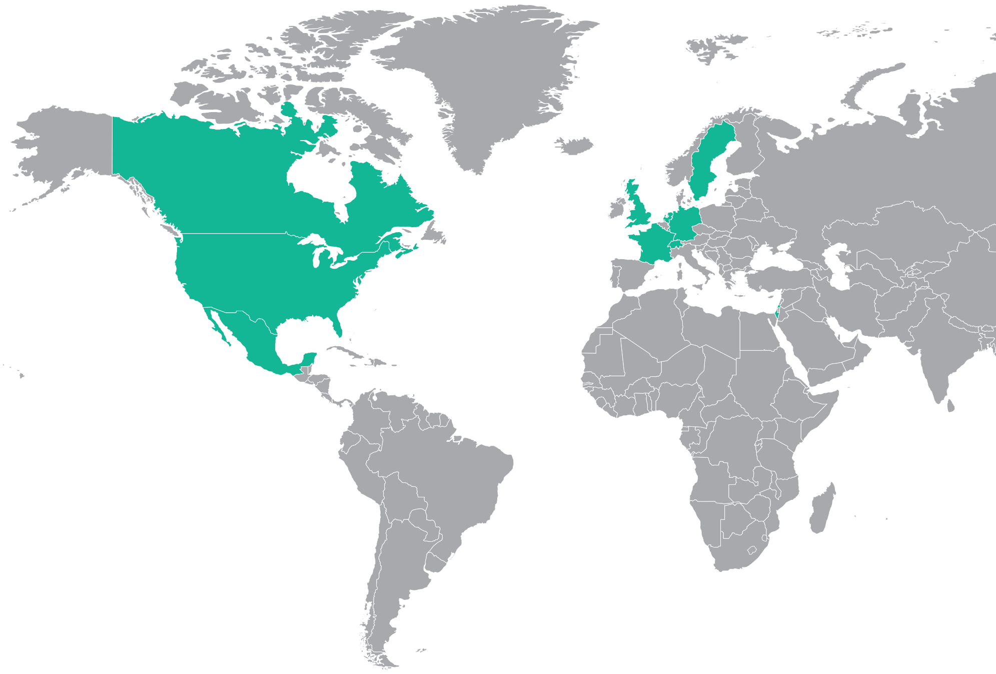
19% SURGE FROM 7% IN CMT COMPANIES WRITING EXCESS LIABILITY

53 CAPTIVES MANAGED FOR CMT ORGANISATIONS

Source: Source: Marsh's 2017 CMT Risk Study

MARSH CAPTIVE SOLUTIONS FOR CMT COMPANIES – SNA

LOCATION OF PARENT COMPANIES	
UNITED STATES	63%
UNITED KINGDOM	8%
CANADA	6%
FRANCE	2%
ISRAEL	2%
GERMANY	2%
JAPAN	2%
LUXEMBOURG	2%
MEXICO	2%
NETHERLANDS	2%
SWEDEN	2%
SWITZERLAND	2%
TAIWAN, PROVINCE OF CHINA	2%



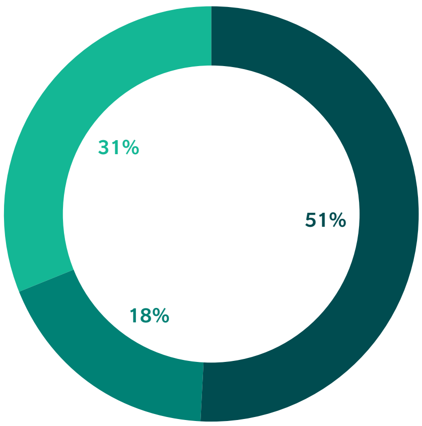
COVERAGES:

TOP 10 TRADITIONAL COVERAGES FOR CMT
ALL RISK
GENERAL/PUBLIC/THIRD-PARTY LIABILITY
OTHER
US TERRORISM RISK INSURANCE ACT (TRIA)/NBCR
WORKERS' COMPENSATION/EMPLOYERS LIABILITY
AUTO LIABILITY
EXCESS LIABILITY
ERRORS AND OMISSIONS
EMPLOYMENT PRACTICES LIABILITY INSURANCE
DIRECTORS AND OFFICERS

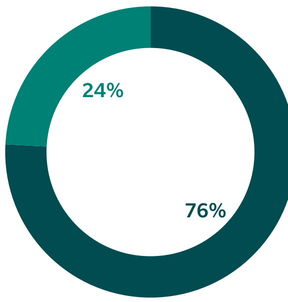
TOP 10 NON-TRADITIONAL COVERAGES
POLITICAL RISK
CYBER LIABILITY
CRIME
TRADE CREDIT
OTHER: EXTENDED WARRANTY
CREDIT DISLIABILITY
CREDIT LIFE
OTHER: CONTRACTOR, VENDOR...
SUPPLY CHAIN (CONTIGENT BUSINESS INTERRUPTION)
SURETY

Captive Solutions 2016 Report: Creating Security in an Uncertain World

CAPTIVE USE BY SECTOR



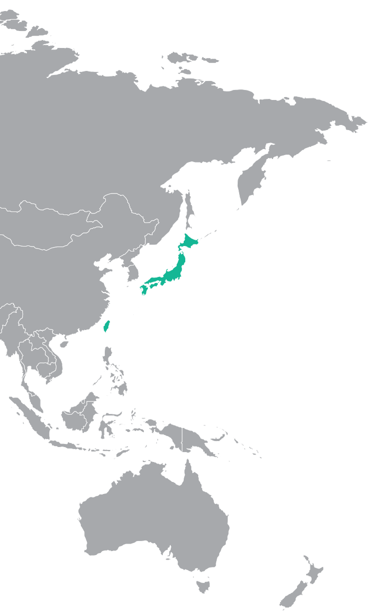
PERCENTAGE WRITING UNRELATED RISK



DOMICILES OF CAPTIVES

20%	Bermuda
16%	US - New York
8%	US - Vermo
6%	US - Utah
4%	US - Delaware
4%	Sweden
4%	Malta
4%	Guernsey
2%	US - Lousiana
2%	US - Connecticut
2%	US - Arizona
2%	Switzerland
2%	Singapor

APSHOT



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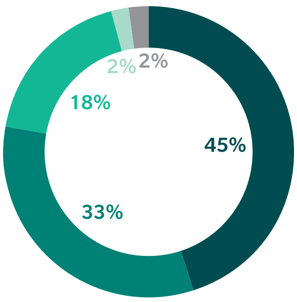
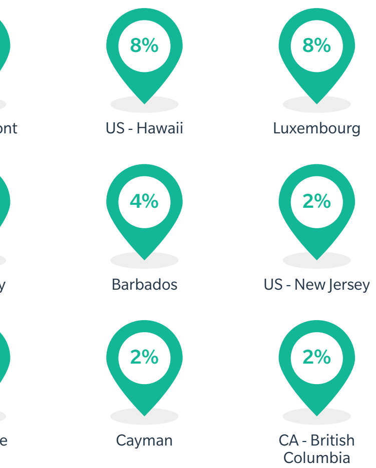
CLAIMS MANAGERS USED



- Third Party
- In House
- Fronting Insurance Company
- Captive Employees
- Not Applicable - Not A Captive



GLOBAL UNCERTAINTIES	GAPS IN TRADITIONAL COVERAGE	CAPTIVE SOLUTIONS
• Emerging cyber risks. • Cyber breach. • Cyber extortion. • Cyber terrorism.	• Terms/exclusions. • Limits/capacity. • Narrow solutions in commercial market. • Property damage as a result of cyber breach. • Injury as a result of cyber breach. • Remediation.	• Ability to tailor policies to meet needs. • Ability to access global reinsurance market for more comprehensive coverage. • Ability to access higher limits with global reinsurance markets.
• Nuclear perils. • Biological perils. • Chemical perils. • Radiological perils. • More frequent terrorism attacks. • More widespread terrorism attacks.	• Excluded NBCR perils. • High retentions. • Greater exposures from globalisation.	• Ability to access government backstop programmes in US, Europe, and many other countries. • TRIA trigger coverage for protection if conditions not met.
• Floods. • Earthquakes. • Hurricanes. • Droughts. • Increased frequency of natural catastrophes. • New exposures due to climate change. • Pandemics.	• Growing exposures due to climate change. • More frequent natural catastrophes.	• As natural catastrophes become more frequent and spread to unprepared locations, the environmental market may begin to harden. Having a captive allows access to less expensive coverage and prepares for a real "worst-case scenario." • Formal funding. • Catastrophe bond access. • Flood, earthquake, and wind. • Insurance-linked securities (ILS).
• Sudden economic downturns. • Fiscal asset bubbles bursting. • Declining oil prices. • Foreign currency devaluation. • Economic duress.	• Unaffordable or unobtainable coverage (risk of a hardening market). • Globalisation increases exposures every day.	• Access to less expensive and more comprehensive coverage. • Access to global reinsurance market. • Better investment philosophy/ fewer restrictions (Mercer investment solutions).
• Political unrest. • Social unrest. • Involuntary migration. • Territorial disputes. • Political violence. • Collapse of State/Country Government.	• Unaffordable or unobtainable coverage (risk of a hardening market). • New and sudden exposures which are difficult to predict due to changing political climate.	• Ability to reinsure a global fronting carrier to retain profits. • Access to cheaper and more comprehensive coverage. • Access to global reinsurance market.
• Ageing workforce. • Rapid digitalisation. • Artificial intelligence. • Increase in contract and remote workers.	• New and emerging exposures are becoming more frequent. • An ageing workforce is creating significant changes to existing exposures. • Artificial intelligence eliminating the need for existing coverages while creating the need for new ones that are difficult to access (cyber). • Wage and hour claims.	• Access to a dynamic insurance vehicle that can proactively address emerging risks instead of reactively responding to them (commercial market). • Captives can offer access to data which is necessary to assess changing risks and exposures within your workforce. • Adding employee benefits to the captive to create financial security and stability: - Employment Retirement - Income Security Act (1974). - Multinational pooling. - Medical stop-loss. - Voluntary benefits.

CMT INDUSTRY FOCUS

RISK INCUBATION

CMT companies are at the forefront of new risks and industries. Often these risks have never existed before and insurers have little experience of underwriting them. This presents serious issues for innovative companies as they may struggle to find effective capacity in traditional insurance markets.

An organisation may be able to use its captive to "incubate" the emerging risks it faces. Under such an approach emerging risks are conservatively underwritten within the captive (and not reinsured) to gain (i) more detailed underwriting information, (ii) develop a more extensive understanding of the risks (which provides a positive feedback loop into more effective risk management), and (iii) build up a known loss history. All three components combined help organisations to better understand and manage the risk, but also provide the platform to explore risk transfer.

An organisation is able to better articulate the risks it faces and also demonstrates confidence in its ability to monitor and evaluate data. Tina Summers, a senior vice president with Marsh's Captive Solutions Practice in San Francisco notes that: "It's a good transition state from being uninsured into a risk transfer programme..."

Risks such as cyber, contingent business interruption, patent, and reputation risks are ideal candidates to be incubated in captives until there is sufficient market capacity, suitable pricing, and adequate appetite available in the commercial market.

INTELLECTUAL PROPERTY

High-tech companies, and CMT companies with significant intangible assets, have become increasingly interested in IP protection as exposure to IP infringement has increased due to non-practicing entities (NPEs) or patent trolls, increasing IP protection and litigation, and greatly increasing reliance on IP for value creation.

As one of their most valuable assets, it is crucial that organisations protect their IP. However, as Marsh's 2017 CMT Risk Study noted, it is difficult to structure products for intangible assets such as IP.

The insurance market has generally responded by adapting existing products, taking a risk management approach, and considering business continuity.

However, while the majority can provide broad and effective intellectual property rights infringement liability coverage, they tend to be highly limited/exclusive when it comes to patent-related litigation.

IP is one of the top non-traditional risks written by CMT captives. By using this method of risk transfer, organisations are often able to access the capacity they require at competitive prices. While the use of captive insurance structures may not be right for every organisation, they may be able to provide options which the commercial market cannot, allowing companies to have a formal, regulated vehicle to fund IP risk stemming from potentially astronomically expensive lawsuits.

Using a captive to fund increasing retentions or gaps in insurance programmes can help to reduce the volatility of retained losses and minimise the balance sheet impact.

SPOTLIGHT

Risks such as cyber, contingent business interruption, and reputation risks are ideal candidates to be incubated in captives until there is sufficient market capacity, suitable pricing, and adequate appetite available in the commercial market.

UNTANGLING THE WEB: SUPPLY CHAIN INTERRUPTION

Business interruption and supply chain losses represent the number one concern for businesses around the globe with average claims 36% higher than direct property claims, according to the Allianz Risk Barometer 2017. Traditional business interruption policies, however, provide only partial protection for losses arising out of supply chain failure.

Supply chain interruption can arise for a range of reasons, however, traditional coverage is typically limited to that arising from physical damage. This falls significantly short for CMT companies who have complex, international, and expansive supply chains with vulnerabilities far beyond physical damage alone.

As the provision of suppliers' extensions on its own is not a comprehensive solution to supply chain risks faced by CMT companies, a better understanding of the supply chain through a thorough review can help to quantify the risk and allow for an informed decision on whether alternative risk transfer is a suitable option.

USE OF CAPTIVES – SOME CHALLENGES AND CONSIDERATIONS

Captives and alternative risk transfer mechanisms can provide an effective risk management and transfer strategy for many CMT companies. However, they are not a solution to all risks faced by these companies. When designing a programme which includes alternative transfer mechanisms, businesses should also consider optimising the overall risk finance strategy to ensure the most efficient levels of risk are retained and transferred.

> "When designing a programme which includes alternative transfer mechanisms, businesses should also consider optimising the overall risk finance strategy to ensure the most efficient levels of risk are retained and transferred."
>
> **LORRAINE STACK**
> MANAGING DIRECTOR
> MARSH CAPTIVE SOLUTIONS

They must also have confidence in retaining esoteric risks under "risk incubator" strategies. Captives also incur administration and finance linked costs such as letters of credit and these administrative costs must also be factored in when consider the overall strategy.

Companies must also be aware of negative correlation. This is where negatively correlated risks can be used to balance the risk portfolio of the business. For example, a company may hedge high-severity, low-frequency intellectual property risks against workers' compensation and employee-related risks (i.e. they have high-frequency, low-severity risks where there is an accurate loss and underwriting record).

As CMT companies look to more sophisticated forms of risk mitigation and transfer to address the specific and unique risks they face, they should consider the overall risk finance optimisation strategy and the available risk finance vehicles. Some risk financing vehicles require significant investment and this should also feature in discussions with an experienced adviser. By viewing risk mitigation through the lens of a journey, companies need to understand the "road to captive" and the benefits their own organisations can derive from embarking on such a journey.

WHO WE ARE

MARSH IS A GLOBAL LEADER IN INSURANCE BROKING AND RISK MANAGEMENT

Our CMT Industry Practice is dedicated to helping you to identify, quantify, manage, and mitigate your composite risks. Many companies that operate in these sectors are on the frontier of emerging risks, pushing boundaries with their business models and disrupting industries. This means they require tailored advice and customised solutions which go way beyond standard.

GLOBAL THOUGHT LEADERSHIP, LOCAL DELIVERY

Access to truly global solutions and advice can be key for CMT companies.

Ranging from rapidly emerging businesses to international conglomerates, we can cover your needs through our international operations in more than 130 countries.

We deliver holistic risk advisory and insurance services across most major and specialist CMT industry risk categories.

MARSH CAPTIVE SOLUTIONS

Marsh Captive Solutions includes the Captive Advisory Group, Captive Management Services, and the Captive Solutions Actuarial Group. We have more than 430 colleagues managing circa 1,250 captives globally. In the industry for nearly 50 years, we have management offices in 18 countries and advisory expertise in retail brokerage offices worldwide. Captive Advisory is the consulting arm of Captive Solutions.

A designated team of expert captive advisers works closely with captive champions in the geographies to deliver best-in-class advice and service from feasibility studies to structuring and implementation of captives. Captive Management Services is an industry leader in designing, implementing, and managing new captives. Once you have decided to develop a captive, Captive Management Solutions can provide the necessary financial, accounting, treasury, and insurance services – from choosing the appropriate location to conducting regulatory findings.

Our Captive Solutions Actuarial Group comprises credentialed actuaries and supporting actuarial analysts who consult exclusively with captive and self-insurance programmes in numerous global domiciles.

INTERNATIONALLY, OVER 2,000 CMT INDUSTRY COMPANIES

50% OF THE WORLD'S LARGEST MOBILE OPERATORS

60% OF THE WORLD'S LARGEST INTERNET COMPANIES

80% OF THE WORLD'S LARGEST SOFTWARE COMPANIES

4 OF THE "BIG 5" GLOBAL ADVERTISING/PR/CREATIVE AGENCIES

OVER 90% OF THE WORLD'S LARGEST INFORMATION TECHNOLOGY COMPANIES

Source: Marsh's 2017 CMT Risk Study

NOTES

88%

OF RISK PROFESSIONALS IN THE CMT INDUSTRIES SAY THEIR COMPANY'S RISKS WILL BECOME MORE COMPLEX AND/OR GREATER IN SCALE IN THE NEXT FEW YEARS.

MARSH'S 2017 CMT RISK STUDY

WHAT IS DRIVING RISK COMPLEXITY FOR CMT COMPANIES?

Rapid innovation broadens the list of potential new exposures.

US$230 billion
invested in the "Internet of Things" in 2016 by US companies; expected to grow to US$370 billion by 2018, according to International Data Corp.

New regulations and contractual risks are increasing.

Data Privacy
The General Data Protection Regulation (GDPR) comes into force in May 2018, meaning businesses will face significantly increased data obligations and potential sanctions.

Mergers and acquisitions, and restructuring increase uncertainty.

11 megadeals
valued above US$10 billion each occurred in the technology industry in 2015 and the first three quarters of 2016.

To explore how our solutions could support your CMT business, please contact your usual Marsh representative or email: national.enquiries@marsh.com.

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SOURCES:

1. MARSH'S 2017 CMT RISK STUDY

In late 2016, Marsh undertook a CMT industry risk study compiling responses from 120 survey respondents across a variety of job functions. Details of the study, as well as the analysis and outputs are available via the following link:

https://www.marsh.com/us/insights/research/communications-media-technology-risk-study-2017.html

2. In 2016, Marsh benchmarked over 1,000 captives managed by Marsh worldwide. The report analysed the current captive landscape and identified utlisation trends. The full report can be viewed here:

Captive Solutions: Creating Security in an Uncertain World
https://www.marsh.com/content/dam/marsh/Documents/PDF/US-en/Captive%20Solutions%20Benchmarking-05-2016.pdf

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