MARSH

THE CAPTIVE LANDSCAPE | MAY 2017

Captives at the Core: The Foundation of a Risk Financing Strategy

How organizations around the world use their captive insurers

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THE CAPTIVE LANDSCAPE | MAY 2017

Captives at the Core: The Foundation of a Risk Financing Strategy

CONTENTS

Introduction

This marks the 10th year that we have published an in-depth captive report. Based on data from over 1,100 captives managed by Marsh, this year's report focuses on understanding how captives are being used depending on geography, risk issue, and/or industry, surfacing opportunities that may exist for greater utilization.

We've seen many changes in 10 years, the most obvious of which is the dramatic rise in numbers: In 2006, there were approximately 5,000 captives globally; in 2016, that number was over 7,000, a 40% increase. And we've witnessed the geographic spread of captives continue, with an increasing number now based in Europe and Asia, solving unique risk issues. But geography and numbers are only part of the story.

Today, global economic and political uncertainty is on the rise, and disruption from technology innovation is growing exponentially, exposing organizations to unfamiliar and sometimes unquantifiable risks. In parallel with these macro trends, more companies than ever see captive utilization as being at the core of innovative risk management strategies.

One indication of that trend is that captives are being used to provide solutions outside of traditional property/casualty programs — for example, in 2016 we once again saw double-digit growth in captive use for cyber risk and employee benefits. As captives are used to address a growing range of risks, they are also helping clients break down operational silos between risk management, human resources, and business development.

The changing risk landscape is also shifting the industries that are leveraging captives. While financial institutions and health care organizations continue to have the highest number of captives, captives in other industries are growing in complexity, which equates to higher premium volumes.

We understand that companies face pressure for growth and must be nimble to reach their financial objectives. We hope you find *The Captive Landscape* insightful, and we invite you to contact your Marsh client service team to discuss the report in greater detail.

Nick Durant
President, Marsh Captive Solutions

40% increase

in total number of captives globally over past 10 years.

Understanding the Steady Growth of Captives

Consistent rise in number of captives is increasingly built on multiple factors

By the end of 2016, there were more than 7,000 captive insurers in operation globally, up from just over 3,000 in 1994.

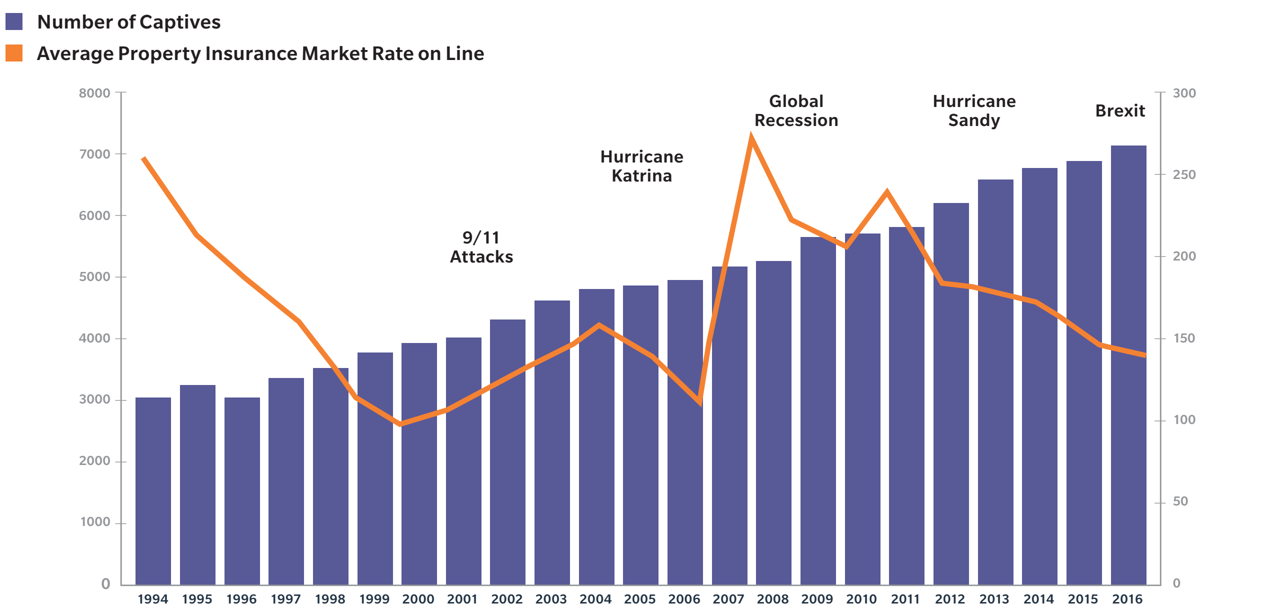
With only one exception (1996), the number of captives has grown every year since. The majority of Fortune 500 companies now have captive subsidiaries, and captives are routinely used by small to middle market companies, too. Many companies now have several captives, some providing coverage for emerging risks, including cyber, political, and other non-traditional exposures.

After more than 20 years of persistent growth, it is clear that the attractiveness of captives stems from an array of benefits, not just one.

Growth in captives globally

Organizations today form captives for a variety of reasons. When comparing the number of captives each year to a measure such as average property insurance rates, it is clear that captives are not only formed in hard insurance markets, as some might assume. Regardless of changes in insurance market conditions or the occurrence of significant catastrophic events, captives remain popular, and growth in numbers has been constant (see Figure 1). In particular, we have seen growing interest in captive formations that solve business unit needs or create a new revenue stream.

FIGURE 1 Market Volatility Does Not Tell the Whole Story of Increasing Captive Formation

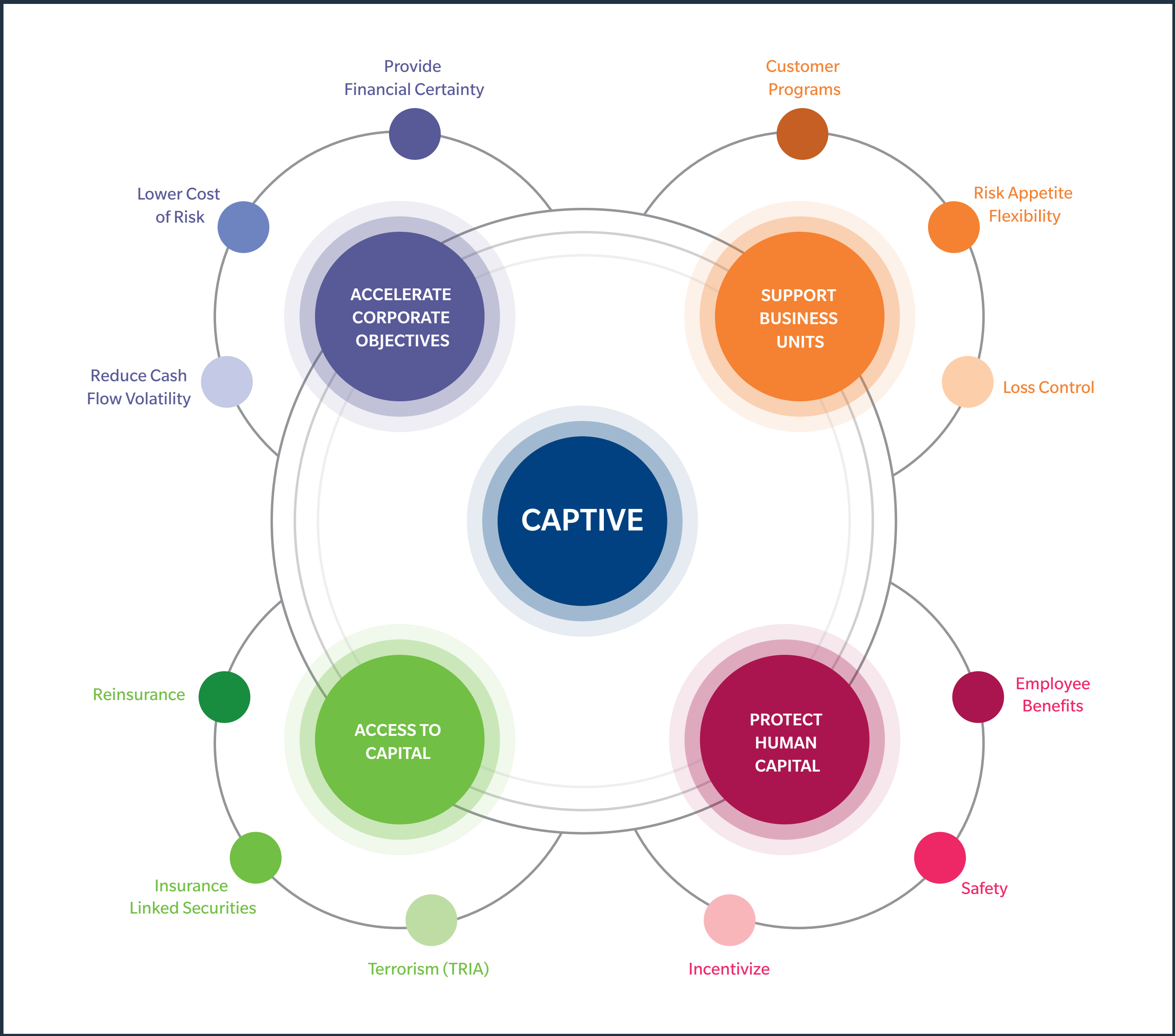


Source of Captive Count: Business Insurance - Special Report, March 7, 2017: 27
Source of Property Insurance Market Rate: Guy Carpenter Global Property Catastrophic Rate-On-Line Index: http://www.gccapitalideas.com/category/chart-room/

IN FOCUS

Captives at the Core of Innovative Risk Management Strategies

As organizations and the risk environment evolve, many organizations are leveraging captives at the core of their risk management strategies. Having captives at the core helps companies accelerate corporate objectives, support business units, access alternative risk capital, and protect human capital.



Top benefits driving captive formation

As organizations' understanding of risk matures, their risk management strategies become more sophisticated, increasing the likelihood of forming or expanding the use of a captive. Funding corporate retained risk is a key value driver of captive formation for 62% of non-US and 74% of US Marsh-managed parents (see Figure 2). A captive structure provides the flexibility to adjust risk retention strategies in response to market cycles or changes in exposures as a result of accelerated growth, mergers, or acquisitions. This puts the captive at the core of a risk manager's toolbox to address traditional property/casualty risks as well as employee and customer risks.

FIGURE 2 Funding Corporate Retained Risk is the Key Value Driver for Forming Captives

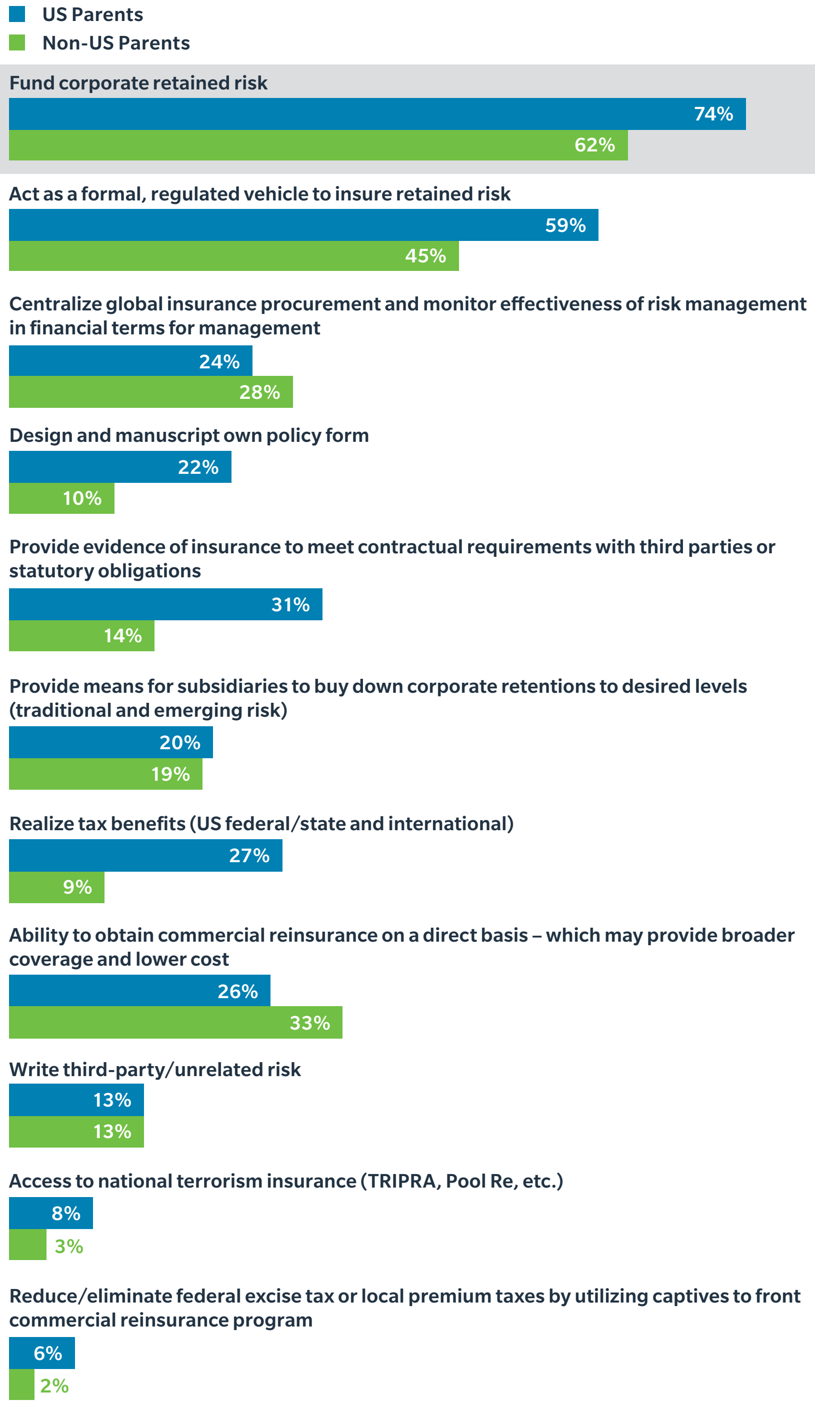
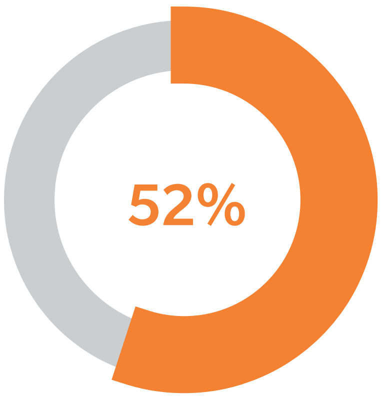


FIGURE 3

More Than Half of Managed Captives Do Not Take US Tax Positions



US tax efficiencies

In 2016, less than 50% of our managed captives took a US tax position (see Figure 3). Realizing tax benefits is the primary benefit to captive formation for only 27% of Marsh-managed captives (see Figure 2), indicating that operational risk management gains are increasingly more attractive driving factors.

For US-owned captives that take a tax position, there are two approaches that are typically taken to meet IRS requirements — underwriting third-party unrelated risk (see Figure 5); or the dominant "brother/sister" approach, which achieves risk diversification through distribution of risk across a parent company's economic family (see Figure 4).

FIGURE 4

Captives Risk Diversification Method

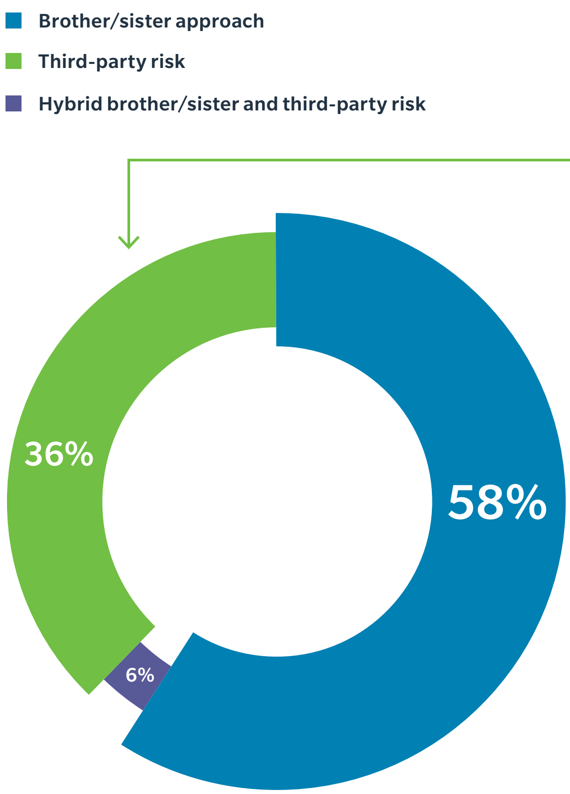


FIGURE 5

Top Unrelated Third-Party Risks Underwritten by Captives in 2016

Of the captives that write unrelated third-party risks:

US Parents	Risk	Non-US Parents
38%	**Customers' programs** (for example, extended warranties, phone protection, and auto rental)	28%
7%	**Multinational employee benefit programs**	39%
37%	**Suppliers, vendors, and/or non-employed contractors**	25%
37%	**US ERISA employee benefits** (group term life, long term disability, accidental death and dismemberment (AD&D)) **or voluntary benefits** (critical illness, accident, or home/auto/umbrella liability insurance)	25%

The Spread Into New Geographies and Industries

Insurance, tax, and legal changes impact growth

Regulatory and tax considerations that fueled offshore captive formation decades ago have been either greatly reduced or eliminated, creating a different environment for newcomers.

In the 1960s, changes in the US tax code, a global capacity shortage, and legislative changes in international finance centers laid the groundwork for a revolution in alternative risk financing. Companies, tired of facing what they perceived to be high premiums, low capacity, and onerous policy language, began forming their own insurance company subsidiaries so they might insure themselves. Today, captive formation is attractive to industries and geographies not traditionally drawn to the option.

Increased attraction in emerging geographies

Historically, most captives were formed by parent companies from North America and Europe, but, over the past three years, we have seen increased interest from emerging geographies. ("Parent companies" own the captive insurer, while a "domicile" is the country or state where the captive is formed.)

Notably, captives formed by parent companies in Latin America increased by 11% in 2016, compared to the previous year (see Figure 6). Latin America's economic growth and increase in risk management sophistication is driving captive interest in the region as companies explore opportunities to stabilize their bottom lines and respond more nimbly to market cycles. Meanwhile, North America and Europe retain the highest number of captives and associated premiums (see Figures 7 and 8), despite experiencing a 2% reduction in licensed captives in 2016.

FIGURE 6

Latin America Dominates in Percentage Growth of Captives by Parent Companies

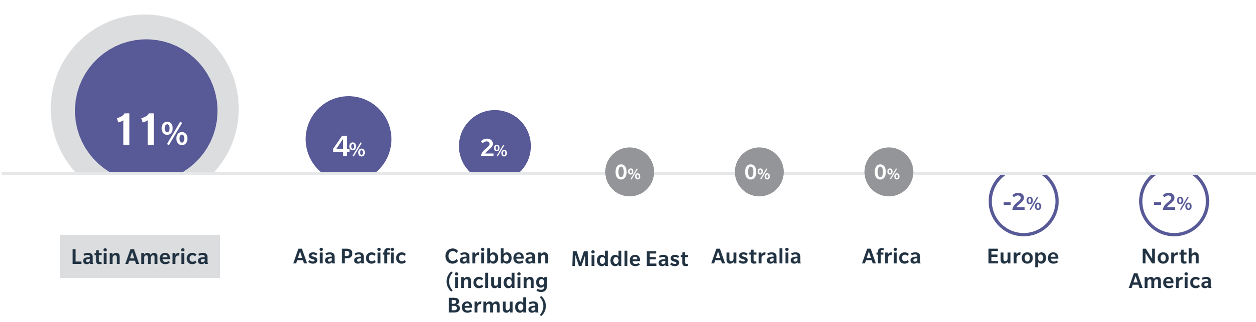


FIGURE 7

North America and Europe Continue to Dominate in Number of Captives

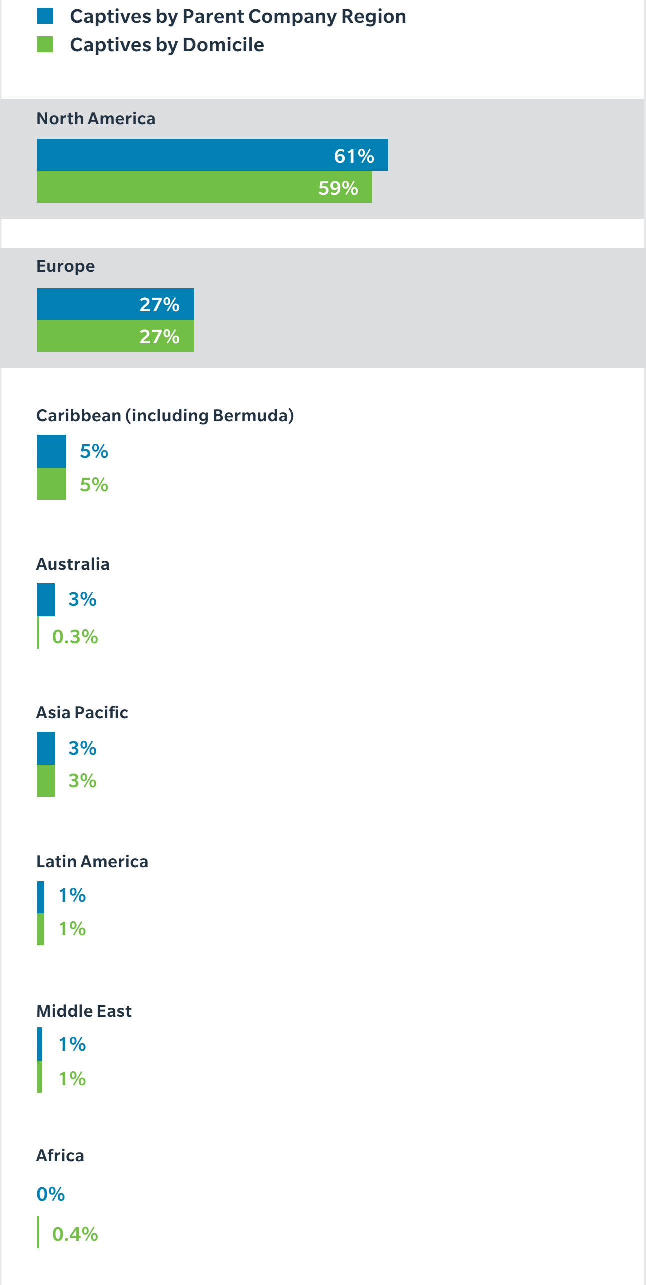
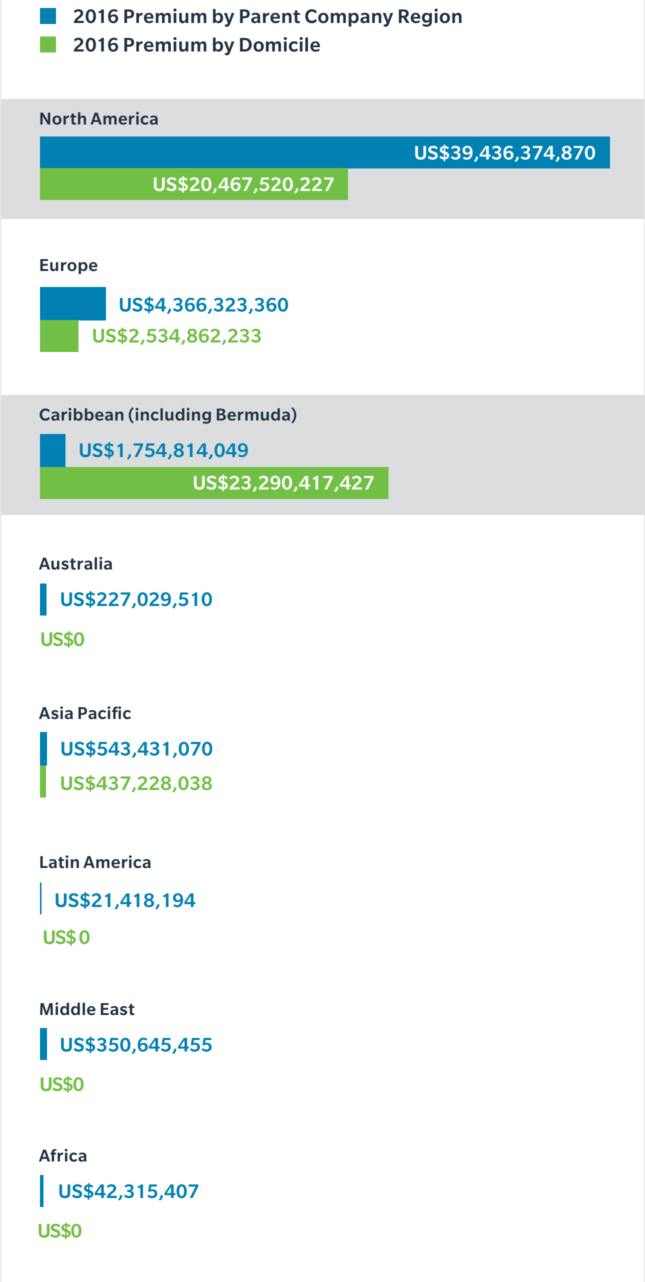


FIGURE 8

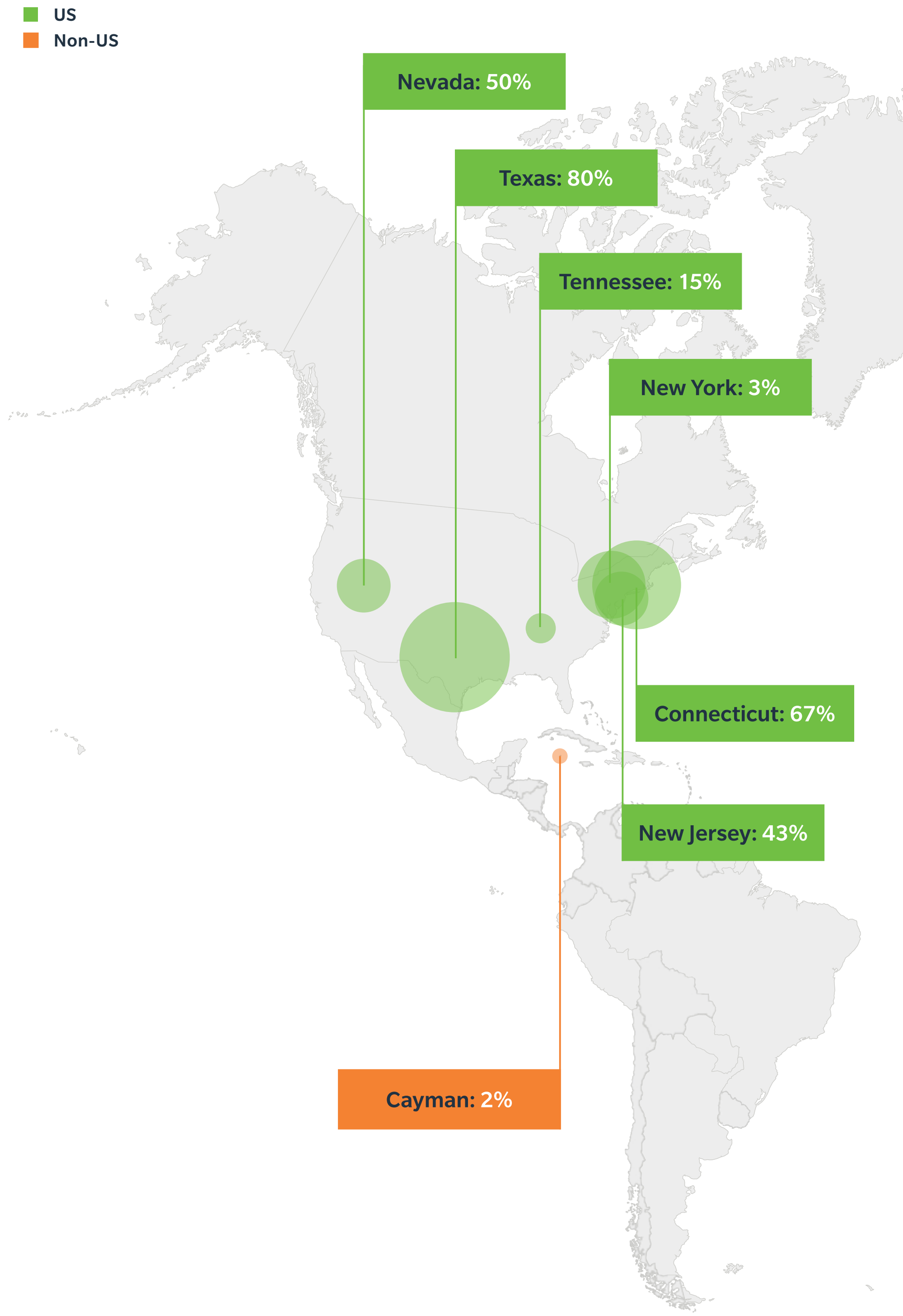
North America and Caribbean Lead in Captive Premiums



New domiciles gaining traction

While traditional domiciles maintained the largest number of captives and premium volume, 2016 saw continued growth in new and emerging domiciles in both the US and overseas (see Figure 9). Top growth domiciles outside the US include Sweden, Guernsey, Singapore, Malta, and Cayman. Within the US, competition among domiciles has increased, and newer domiciles are experiencing growth. Texas, Connecticut, Nevada, New Jersey, Tennessee, and New York were the top-growing domiciles in 2016.

FIGURE 9 Competition and Regulation a Factor in Year-Over-Year Domicile Growth




Sweden: 25%
Guernsey: 16%
Malta: 4%
Singapore: 10%

TAX AND REGULATION WATCH

“BEPS Package” Puts Captives Under Greater Tax Scrutiny

Following some highly publicized cases, captives have been a focus for the Organisation for Economic Co-operation and Development (OECD) as potential vehicles for tax avoidance, via intra-group (related party) transactions known as base erosion and profit shifting (BEPS) situations.

Tasked by the Group of Twenty (G20) countries to review tax avoidance by multinational companies, the OECD issued its final report in October 2015, with 15 recommendations called the BEPS Package.

To date, over 30 countries (not currently including the US) have effectively adopted certain OECD recommendations through signing up to the Country-by-Country Reporting Implementation Package (CbC Reports), which began in 2016.

Positive Changes to 831(b) Election

On January 1, 2017, new US legislation impacting captives taking an 831(b) election went into effect. Among the changes, the premium threshold almost doubled, to US$2.2 million, leading to increased formations and captive utilization. The legislation calls for additional tests for captives to demonstrate appropriate risk diversification.

Growing complexity drives premium volume in captives

Captives are well known for their use in certain industries, including financial services, health care, and manufacturing, which continued to dominate in 2016 (see Figure 10). However, the increasing complexity of risk and the pace of emerging risks has led other industries to adopt or expand their use of captives, as noted in premium size. Concerns vary greatly by industry. Given this challenging environment, businesses in all industries and of all sizes are exploring captive utilization for non-traditional risks.

FIGURE
10

Financial Institutions Still Lead the Way in Number of Captives, But High Captive Utilization Spans Numerous Industries

Percentage by Number of 2016 Captives		Premium Volume of 2016 Captives
24%	Financial Institutions	US$24,590,900,884
12%	Health Care	US$2,058,491,682
7%	Manufacturing	US$1,325,169,540
6%	Retail/Wholesale	US$2,079,570,549
5%	Construction	US$291,735,058
4%	Communications, Media & Technology	US$4,872,307,853
4%	Transportation	US$938,123,258
4%	Power & Utility	US$839,130,666
3%	Other Services	US$524,282,103
3%	Energy	US$592,489,653
3%	Real Estate	US$82,123,740
3%	Chemical	US$287,423,741
3%	Automotive	US$244,732,345
2%	Mining, Metals & Minerals	US$623,252,794
2%	Food & Beverage	US$964,015,319
2%	Misc. Other	US$3,359,705,962
2%	Life Sciences	US$1,311,593,286
2%	Marine	US$700,942,832
1%	Education	US$57,453,610
1%	Agriculture & Fisheries	US$113,427,455
1%	Aviation, Aerospace & Space	US$389,259,718
1%	Professional Services	US$250,197,598
1%	Public Entity & Not-For-Profit	US$29,936,220
1%	Sports, Entertainment & Events	US$17,552,457
1%	Forestry & Integrated Wood Products	US$170,211,424
1%	Hospitality & Gaming	US$28,322,170

IN FOCUS

Captives Contribute to a Surplus "War Chest"

Captives back policies with capital but, as with any insurer, these assets can accumulate as reserves and shareholder funds over time. Marsh-managed captives, for example, currently have more than US$110 billion in shareholder funds, providing owners with the means to reduce their total cost of risk in creative ways.

As organizations' exposures increase in number, complexity, and severity, the shareholder funds generated by captives are playing an ever more important role. For many clients, captives are at the core of their risk management strategy, going beyond the financing of traditional property/casualty risks.

Specifically, we are seeing an increase in parent companies using captive shareholder funds to underwrite an influx of new and non-traditional risks, including cyber, supply chain, employee benefits, and terrorism, as well as to develop analytics associated with these risks and fund other risk management initiatives.

Risk management projects funded by captive shareholder funds in 2016 included initiatives to determine capital efficiency and optimal risk retention levels in the form of risk-finance optimization; quantify cyber business-interruption exposures; accelerate the closure of legacy claims; and improve workforce and fleet safety/loss control policies.

US$110 BILLION+

in current total shareholder funds[1]

Captive Surplus by Industry[2]

[1]Total shareholder funds include net retained earnings plus capital contributions.
[2] Marsh-managed captives only.

Multinationals Turn to Captives for Complex and Costly Risks

Employee Benefits

The number of Marsh-managed captives reinsuring multinational employee benefit risks continues to increase. Companies need to create efficiencies as they face the triple threat of medical insurance cost inflation (nearly 10% globally for three years running), an aging workforce, and a shift in responsibility for providing benefits from governments to corporations.

The cumulative costs to insure employee benefit risks often exceed those of global property and casualty insurance, yet benefit financing and governance is far less sophisticated. We expect continued growth in captives writing multinational employee benefits over the next three to five years as service support eventually follows a similar structure to global property and casualty programs, which are centrally controlled with consistent and transparent governance.

Recent employee benefit captive implementations have been carried out by European multinationals, reflecting increased sophistication among European captives in response to Solvency II, along with an increased appetite for captives. However, no one region, industry, or domicile leads the global charge.

The common thread is an appetite and means to drive operational transformation.

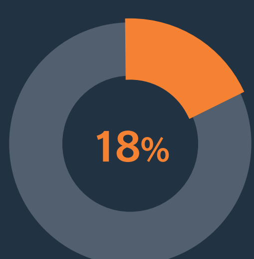
Cyber Liability

We continue to see double-digit year-over-year growth in the number of organizations using captives to write coverage for cyber liability. Marsh-managed captives using cyber liability programs increased by nearly 20% in 2016 over 2015; since 2012, cyber liability programs in captives have grown by 210%.

We expect to see a continued increase, driven in part by companies that are already strong captive users and by those that may have difficulty insuring their professional liability risks.

The potential advantages to using a captive for cyber liability include accessing reinsurance for CAT limits, filling gaps in standard cyber policy language, securing coverage for emerging and unique cyber risks, and consolidating cyber programs across operating companies.

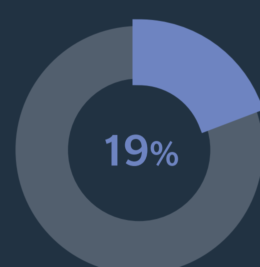
Year-Over-Year Growth in Captives Underwriting Multinational Pool Benefits



Top Industries With Captives Writing Multinational Pool Benefits

- Communications, Media & Technology
- Financial Institutions
- Mining, Metals & Minerals
- Retail/Wholesale, Food & Beverage

Year-Over-Year Growth in Captives Underwriting Cyber Liability



Top Industries With Captives Writing Cyber Liability

- Communications, Media & Technology
- Financial Institutions
- Real Estate/Hospitality & Gaming
- Retail/Wholesale, Food & Beverage
- Transportation

Captive Structures Offer Flexibility

Single-parent captives continue to dominate

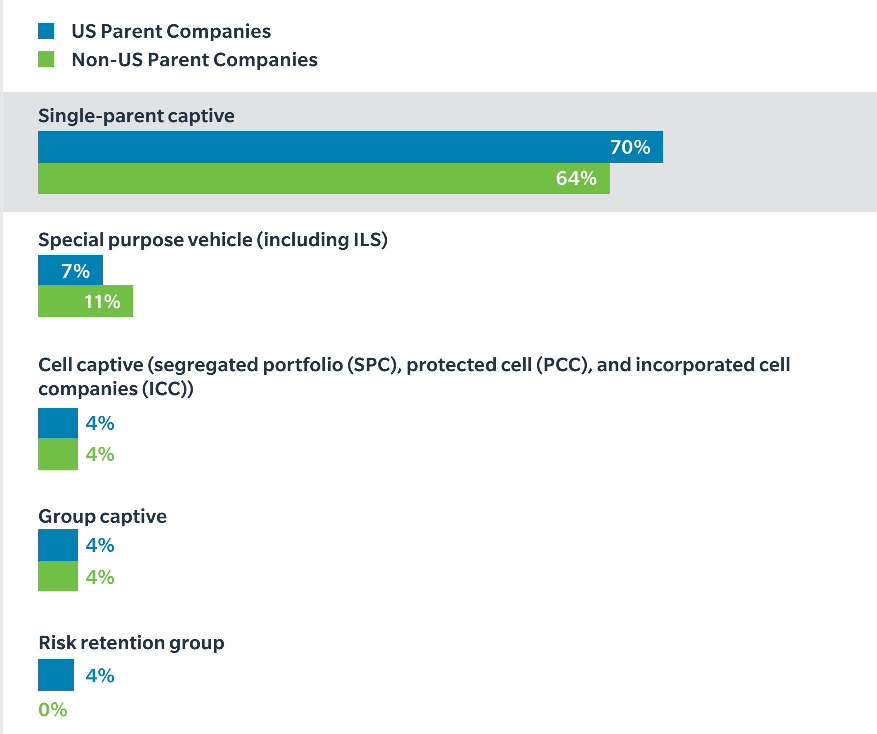
Captives come in many shapes and sizes and provide companies with tremendous flexibility in terms of how they structure risk financing.

Risk-financing vehicle structures

While single-parent structures dominate (see Figure 11), special purpose vehicles (SPVs) are popular among banks and commercial insurers.

The most common domiciles for SPVs include Dublin, where innovation in financial transactions is fostered by Ireland's robust yet flexible regulatory environment, and Bermuda, where entities can access catastrophe bonds for large-scale, long-term durations (see Figure 12). In the US, Vermont and South Carolina have significant experience with life insurance entities establishing captives for XXX and AXXX capital relief efficiencies.[3]

FIGURE 11 Single-Parent Captives Remain Domininant Structure



[3]XXX and AXXX are designations applied to types of reserves for certain term and universal life insurance policies.

FLEXIBLE CAPTIVE STRUCTURES

Single-Parent Captive: A wholly owned structure controlled by one company and formed to insure or reinsure the risk of the parent and/or unrelated parties of their choosing.

Special Purpose Vehicle (SPV): A subsidiary company with an asset/liability structure and legal status designed to make its obligations secure even if the parent company goes bankrupt; these are generally used to house asset-backed securitizations, protect organizations from financial risk, or manage capital and surplus.

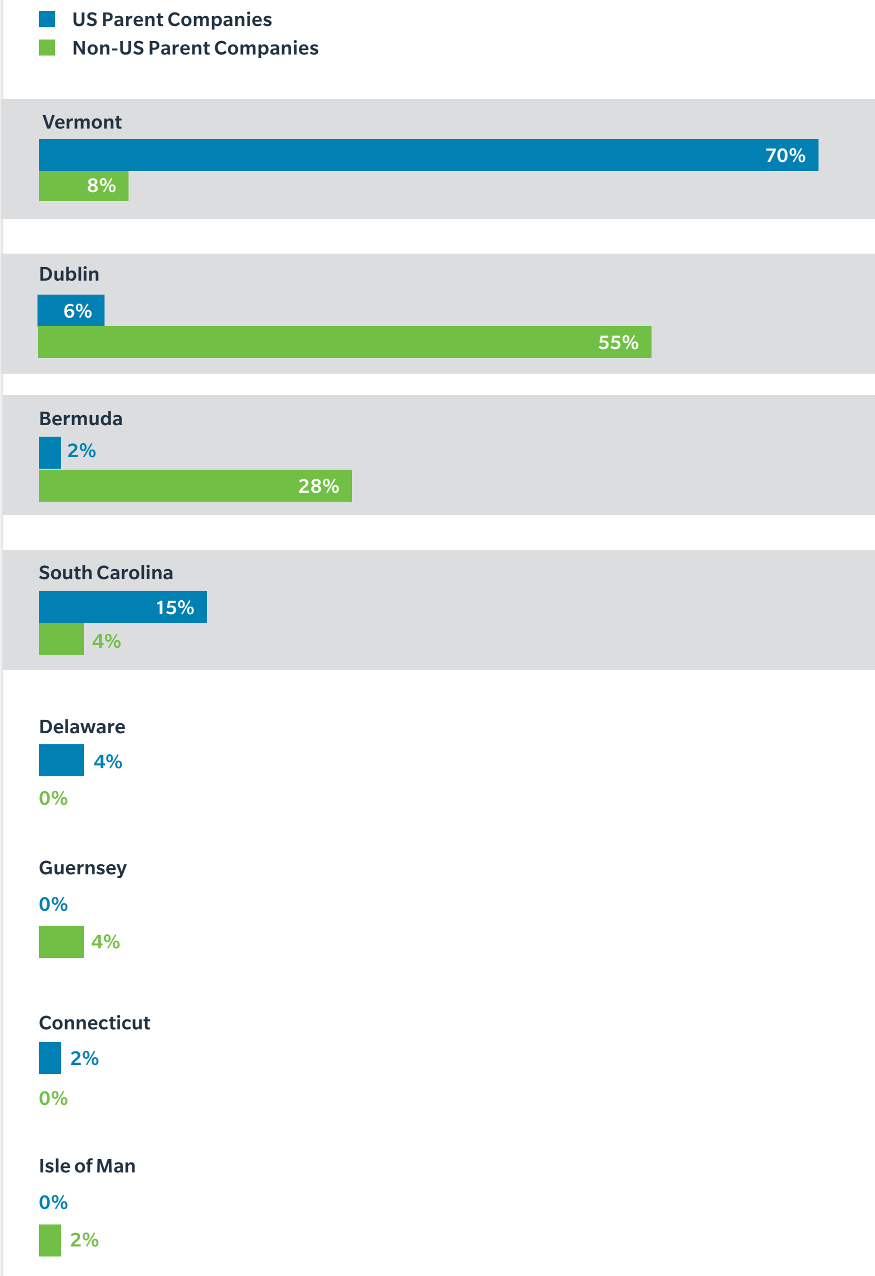
Cell Captive: A captive formed by a third-party sponsor that "rents" cells to outside companies; the liabilities and assets of each cell are separate from other cells, and each cell owner is usually required to capitalize that particular cell.

Group Captive: Owned and controlled by multiple companies to insure or reinsure the risk of the group.

Risk Retention Group (RRG): A structure that requires owners to be insureds of the RRG and that may write only liability coverage on a direct basis to its participants and can operate in all 50 US states on an admitted basis, yet is required to be licensed only in its state of domicile.

FIGURE 12

Bermuda, Dublin, and Vermont Dominate Special Purpose Vehicles in 2016



CAPTIVES TURNING TO ALTERNATIVE CAPITAL

Captives have increasingly used insurance linked securities (ILS) to access reinsurance — especially where there is limited capacity in the current markets for the type and level of risk involved — and as a way of diversifying their reinsurance towers.

For example, an ILS can be structured so that a parametric trigger of certain intensity measurements, such as storm surges, will prompt catastrophe bonds. Or, for captives placing a higher layer of their reinsurance tower through an ILS structure, the parent company can access collateral funds for low frequency/ high impact events in a relatively short time frame. There may also be positive solvency capital implications (especially with Solvency II) as the captive can provide collateral rating transparency.

Future options for the use of ILS vehicles as a complementary form of reinsurance appear unlimited, especially as the capital market investors that are interested in this area become more sophisticated in their underwriting capabilities.

44% of captives

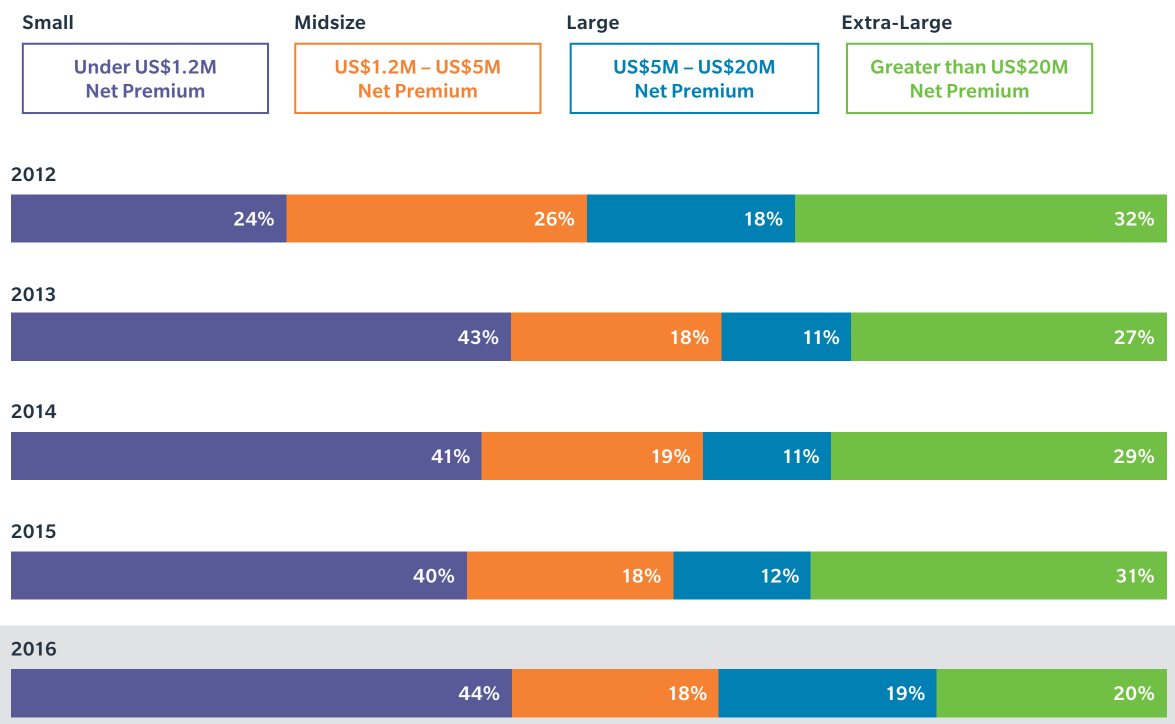
categorized as "small" in 2016

Size of captives shifts

Traditionally, extra-large captives — generating more than US$20 million in premiums annually and mostly established by FTSE 100 or Fortune 500 companies — dominated the landscape. In 2016, however, extra-large captives made up only 20% of the total, due to consolidation within certain industries, such as health care (see Figure 13).

Small captives now account for almost 44% of captive insurers, up from 24% in 2012. We've also seen an increase in midsize captives that have grown into large captives. Generally, we believe captive formation should take a phased approach, with a three- to five-year growth plan that starts with the biggest opportunity and evolves with the parent's risk management philosophy.

FIGURE 13 Small- and Middle-Market Captives Increase, While Extra-Large Captives Decrease



Note: Percentages in a given year may not add to 100% due to rounding.

Geopolitical Events Impact Captives

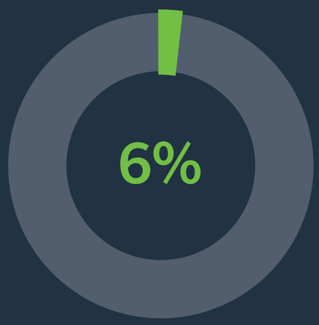
Global companies face mounting geopolitical concerns, as evidenced by rising nationalism, continuing terrorist attacks, and unanticipated election results, such as Donald J. Trump becoming US president and the UK vote to exit the European Union (EU). In a recent Marsh survey, more than half of risk professionals said events in 2016 caused them to pay more attention than ever to political risk.

The potential impact of the changing landscape on captive owners is unclear. For example, the Trump Administration has promised to push through major cuts to business tax rates, invest in infrastructure, and repeal financial regulations such as Dodd-Frank. Likewise, we know that the UK's Brexit vote could directly impact captives' "passporting" rights, affecting collaboration among EU member states.

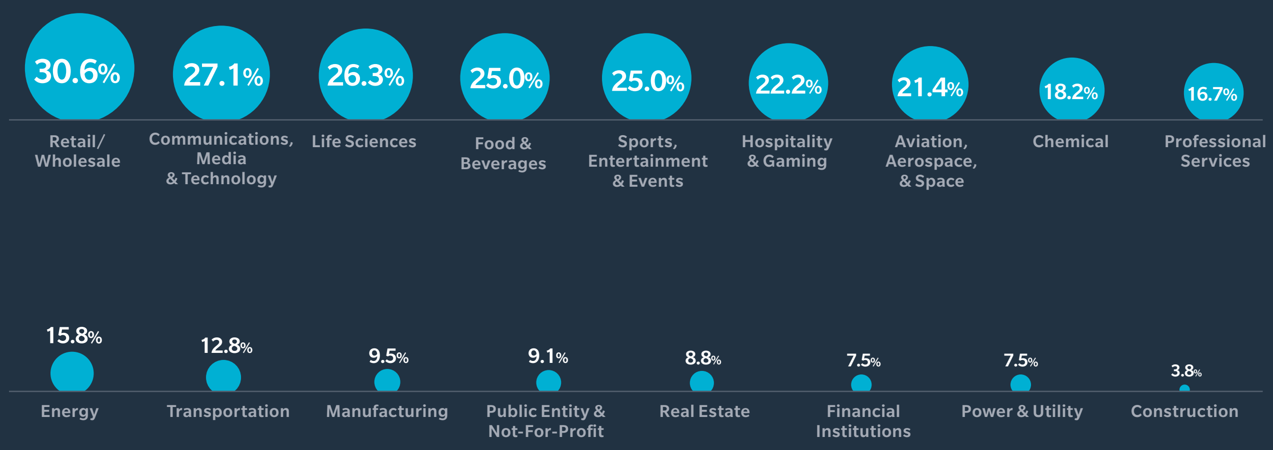
One thing is clear: Parent companies concerned about economic volatility, rule of law, and government instability are using their captives as a lever to address complex coverages related to geopolitical risk. As risk appetites change in response to global events and market cycles, captives are able to respond nimbly.

As US-domiciled captives are obligated to offer terrorism insurance under the Terrorism Risk Insurance Program Reauthorization Act of 2015 — the federal terrorism insurance backstop — organizations are carefully examining their captive structures and TRIPRA's requirements to ensure compliance and to take advantage of the program. As the dynamics of terrorism risk evolves, we expect the number of captives opting for TRIPRA and writing standalone terrorism coverages to continue to increase.

Captives Underwriting Standalone US Government Terrorism Backstop in 2016



Increase in Captives Writing Terrorism Coverage in 2016 Over 2015, by Industry



More onshore captives than offshore

While 51% of gross written premium generated by captives remains in offshore vehicles (see Figure 14), onshore captives — defined as Australia, Dublin, Luxembourg, Malta, Singapore, Sweden, and the US —account for 58% of the total worldwide (see Figure 15). ("Offshore" captives account for all other regions not noted as being "onshore.")

The re-domiciling of a captive is driven by the evolving needs of the parent company. Since 2011, re-domestications have remained relatively flat (see Figure 16), but there has been an increase between US domiciles, with six captives re-domiciled from one state to another in 2016. This movement is due to states such as Georgia, Illinois, and Texas, in particular, revising statutes to incentivize home-state parent companies to re-domesticate captives.

FIGURE 14 Onshore vs. Offshore Captives by Gross Written Premium in USD

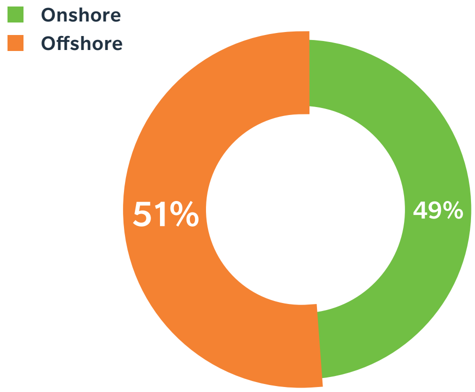


FIGURE 15 Onshore vs. Offshore Captives by Total Number of Captives

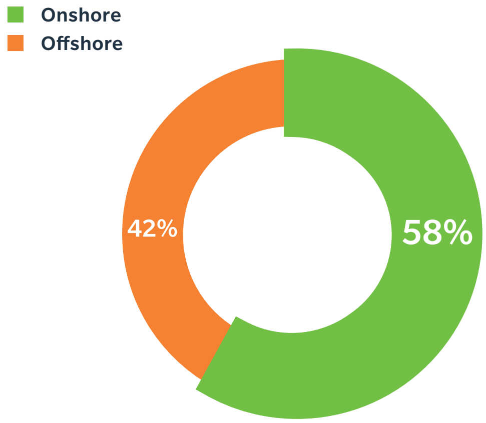
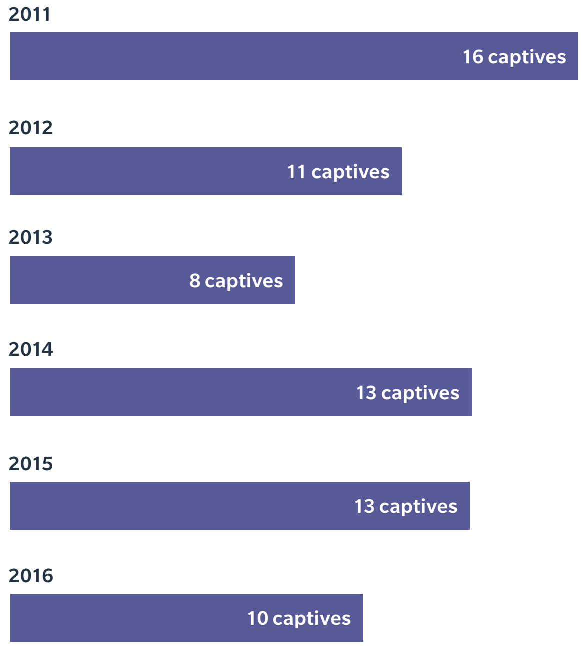


FIGURE 16 Re-Domiciling of Captives (2011-2016) Remains Flat Year-Over-Year



“More companies than ever see captive utilization as being at the core of innovative risk management strategies.”

— NICK DURANT, PRESIDENT, MARSH CAPTIVE SOLUTIONS

Recommendations

Already a captive owner? Challenge the status quo.

Evaluate how your business and risk management strategies have changed since the captive was formed and ask questions, including:

- Is the captive aligned with accelerating our corporate objectives?
- How are my peers using their captives for certain risks?
- How can our captive respond to emerging risks?

Considering captive formation? Take a fresh look.

Organizations of all sizes and industries are benefiting from captives in new ways, including:

- Supporting business units by creating a profit center.
- Reducing cash flow volatility from underinsured or uninsured risks.
- Protecting human capital by underwriting employee benefits and/or providing surplus capital that can be used to fund employee safety programs.

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ABOUT MARSH

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ABOUT THIS REPORT

Except as indicated, all data in this report is based on 1,100 Marsh-managed captives who agree to share their data on an anonymous and aggregated basis. Clients can opt out of the analysis.

MARSH