New Ways to Use Surplus

There is a move toward captives' strategic use of surplus to fund risk management-based projects, analytics, consulting and more.

By Alex Wright

Surplus from captives is enabling companies to reinvest in their strategic priorities.

Surplus produced by captives traditionally found a use in taking on additional limits, writing new lines of business or funding loss control. But as more captive owners start to write emerging risks such as cyber, supply chain and terrorism, there is a move toward using surplus to fund a variety of risk management-based projects and analytics associated with these risks.

With most mature captives accruing surplus from multiple years of positive underwriting performance — most notably financial institutions, which stood at $40 billion in 2016, according to Marsh — that trend is only going to accelerate.

In the last year alone, surplus use extended to 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.

One major U.S. retailer, whose workers' compensation program reported deteriorating loss experience at the same time the company was grappling with a large-scale acquisition, used its captive's $50,000 surplus to fund additional external safety and loss prevention consulting in order to boost its internal resources. Building on that, the surplus was used in subsequent years to fund additional risk consulting services.

"Surplus has become part of a much larger debate around data, customer information and how that can be used to maximum effect," said Ward Ching, managing director, Aon Captive & Insurance Management. "Clients are now asking strategy-related questions about business growth, product-service mix and market penetration and captives are at the heart of that because they hold much of that data and the analytical capability to achieve a lot of those things."

CENTRAL TO RISK MANAGEMENT STRATEGY

Ellen Charnley, president, Marsh Captive Solutions, said companies increasingly put their captive at the heart of risk management and risk finance strategy, going beyond the financing of traditional property and casualty risks.

"This means that the captive isn't simply doing what it maybe historically did 10 years ago, just funding for the retentions and deductibles," she said. "Now it's looking to potentially take on greater risk and to reduce the amount of commercial insurance risk transfer transaction, for example, in buying commercial insurance.

"Also, companies are looking potentially to structure deals whereby there's much greater retention in the captive and buy higher level coverage to protect the captive through the reinsurance market. That structure is one a lot of companies, particularly the larger ones, are looking for as they get more comfortable in retaining risk, and in that respect, the role of the captive and the risk manager has been elevated."

"There's more sophistication with respect to analytics and the captive's role to play in that."

— Ellen Charnley, *president, Marsh Captive Solutions*

In terms of surplus use, Charnley said that captives are increasingly being used to fund analytical work focused on retentions.

"There's more sophistication with respect to analytics and the captive's role to play in that," she said.

"The cost of that analytical project work is now being borne by captives using their potential profits and surplus they have developed over the years."

Another example, said Charnley, was using a captive to fund an actuary who can understand, predict and quantify a company's known risks. The surplus can also be used to fund analysis of the company's existing book of claims in order to speed up claims closure and where necessary, to challenge claims adjustors, ultimately lowering the cost of risk in the long run, she said.

"Predictable risk is always an area for companies to try and improve

SUMMARY

- ***Captives are becoming*** vital to risk management and risk finance strategy.
- ***Risk management-based projects*** are funded by some companies with captive surpluses.
- ***Surplus is being*** deployed to write non-traditional emerging risks.

upon, so through loss control activities, for example, the cost of workplace environmental changes, to try to reduce workers' compensation exposures and ultimately claims, can be borne by the captive," she said.

"The captive, in turn, would benefit from a reduction in claims in addition to those of the parent."

Sean Rider, managing director for consulting and development, Willis Towers Watson's Global Captive Practice, said he has seen a trend toward using captives to fund more sophisticated analytics around risk finance optimization. That includes the use of analytics to understand the optimization of their risk financing programs, he said.

"Captives for large global corporates are coming into their own as a repository for retained risk and a hub for executing risk financing programs that rely on the company's balance sheet to manage the lion's share of the organization's risk portfolio," he said.

Captive Use Across Industries

Percentage by Number of 2016 Captives		U.S. $ Premium Volume of 2016 Captives			U.S. $ Premium Volume of 2016 Captives
24%	Financial Institutions	$24,590,900,884	2%	Mining, Metal, Minerals	$623,252,794
12%	Health Care	$2,058,491,682	2%	Food & Beverage	$964,015,319
7%	Manufacturing	$1,325,169,540	2%	Misc. Other	$3,359,705,962
6%	Retail/Wholesale	$2,079,570,549	2%	Life Science	$1,311,593,286
5%	Construction	$291,735,058	2%	Marine	$700,942,832
4%	Communications/Media & Tech	$4,872,307,853	1%	Education	$57,453,610
4%	Transportation	$938,123,258	1%	Agriculture/Fisheries	$113427,455
4%	Power& Utility	$839,130,666	1%	Aviation, Aerospace & Space	$389,259,718
3%	Other Services	$524,282,103	1%	Professional Services	$250197,598
3%	Energy	$592,489,653	1%	Public Entity & Not-For-Profit	$29,936,220
3%	Real Estate	$82,123,740	1%	Sports, Entertainment & Events	$17,552,457
3%	Chemical	$287,423,741	1%	Forestry & Integrated Wood Products	$170,211,424
3%	Automotive	$244,732,345	1%	Hospitality & Gaming	$28,322,170

SOURCE: MARSH

"To have a rational approach to running such a risk financing program, they need to have a robust analytical basis to their decision making.

"This is further supported by the re-emergence of the integrated marketplace in alternative risk transfer and the refocusing of large corporates in terms of optimizing their risk transfer/retention program."

Jason Flaxbeard, senior managing director, Beecher Carlson's Captive Services Practice, said some companies were centralizing their risk by using the surplus from their captive to finance their risk management team. Another use, he said, was paying for risk inspections and engineering visits for those captives that write property.

"We also have some clients who now want to use their surplus to take on enormous chunks of their own risk," he said.

"Clients are now asking strategy-related questions about business growth, product-service mix and market penetration and captives are at the heart of that because they hold much of that data and the analytical capability to achieve a lot of those things."

— ***Ward Ching,*** *managing director, Aon Captive & Insurance Management*

NEW RISKS

Another area in which surplus is being deployed is in writing non-traditional emerging risks. Nancy Gray, managing director, Aon Global Risk Consulting, said cyber is one such area.

"Going down this route allows companies to potentially increase their retentions and be more flexible in how they want to structure their insurance programs," she said.

"Increasingly, there is also an opportunity for companies to extend beyond their own P&C risks and take on their customers' risks through their captive program."

Courtney Claflin, executive director of captive programs at the University of California, who manages two captives, said the university is using the original captive to fund a grant program for risk management and safety needs.

"We can play a role throughout the university system by creating a grant program to help individual departments or campuses that need funding for specific projects like campus security," he said.

"The grant program allows them to write a grant proposal to the captive and then we can use the captive surplus to fund that grant."

Ian Davis, the State of Vermont's director of financial services, said companies are increasingly looking at new and innovative ways to deploy the surplus capital from their captive.

"The trend I see is that some captives have built up such a large amount of surplus, that they do studies to determine the appropriate use of and place for the capital in their organization," he said.

Charnley added, "Surplus is another compelling value proposition that captives provide that perhaps otherwise would be lost in the parent company's balance sheet. Having a separate pot of money that can be used in this way can be a tremendous benefit to a company." &

ALEX WRIGHT is a freelance writer based in the United Kingdom. He can be reached at riskletters@lrp.com