STRATEGIC REVIEW OF BENELUX CAPTIVE MARKET

Dr Paul Woehrmann and Dirk de Nil, of Zurich, consider the strategic possibilities within the Benelux captive owner market in view of the current activity within the M&A insurance environment

Dr Paul Woehrmann

Dr Paul Woehrmann is head of captive services Europe, Middle-East, Africa, Asia Pacific and Latin America, was ranked the third most influential person in the industry by Captive Review in 2016 and 2017. He has been with Zurich for more than 25 years and leads a team of experts which is located in several countries across the world in order to meet non-life and life requests from captive owners. Woehrmann studied economics at the universities of Hamburg, Cologne and Fribourg (Switzerland).

Dirk De Nil

Dirk De Nil is chief executive officer of Zurich Benelux since February 2018. De Nil is an internationally experienced manager with a proven track record of successfully fixing, building and leading global insurance functions and local and regional market facing insurance businesses. Following one year in 2017 as CEO Allianz Morocco, Dirk De Nil returned to Zurich, which he initially joined in 2008. He holds a Master of Law degree from the University of Gent (Belgium).

The Benelux captive owner market comprises more than 50 ultimate captive parents which is, compared to other countries in Continental Europe, a large number. Most of the Belgium captive owners have located their captives in Luxembourg. A substantial number of Dutch captive parents run their captive operations in the Netherlands. Our European portfolio shows that, on average, each captive owner runs at least two major fronting programmes.

Captive owners as partners of the insurance companies

The majority of captive reinsurers have embedded non-proportional reinsurance structures within primary layers, including annual or term aggregates to protect the captive balance sheet against unexpected losses. We have experienced that large European captive owners cede around 80% of the entire gross written premiums back to their captives, whereas on the retrocession level two different risk transfer strategies can be observed. On the one hand are the net cessions protected by cross-class aggregates and on the other the set-up of retrocession panels behind the captive. We have experienced that large European captive owners generate a gross written premium volume with regards to the fronted lines of business in the range of €60m-€100m ($74m-$123m).

The excess layers typically stay with the fronting insurer either on a net or partially co- or reinsured basis. All captive owners are very keen to run a profitable business under underwriting considerations. They therefore constantly try to reduce the cost of risk and protect profitability by introducing appropriate risk control measures, which reduce the frequency of claims and the cost of premiums. Once the primary layer is running profitably, it is highly likely that excess layers will follow the same path.

The related reinsurance commissions also contribute to the financing of the fixed costs of the fronting insurers' international networks.

The majority of captive customers are interested in a long-term business relationship for the benefit of themselves and the fronting insurers. We have experienced over many years a respective retention rate of 90%. However, captive reinsurance has become more difficult in Europe – for fronting insurers and captive owners – due to Solvency II and the OECD framework on Base Erosion and Profit Shifting (Beps). This has already resulted in captive closings, run-off scenarios or moves from a captive operation to a virtual captive like the Protected Cell Company structures available in certain Solvency II jurisdictions.

Latest market concentration

The insurance and reinsurance markets are in motion, and over time could consolidate even more. The last announcement of a global merger took place on 5 March 2018. The former independent operating corporate insurers Winterthur International, XL, Catlin and AXA will all become one big family under AXA Group.

Hence, the number of choices for insurance buyers gets further reduced.

The increasing M&A activity in the insurance and reinsurance sector could become a concern for large multinationals when selecting global insurance providers, because their options might become very limited. As a reaction, large corporate insurance customers might try to pursue stronger market arbitrage via their captives to avoid falling victim to an 'oligopoly trap' and to respond to the insurance market cycle dynamics. On the other hand, international companies which do not have access to a captive or virtual captive can't respond in the same manner.

A more active utilisation of reinsurance captives could in turn lead to an additional fee-opportunity for fronting insurers, if they are experienced and flexible enough to serve reinsurance captives in an efficient manner.

A professional captive fronting partner should be capable of:

- Simplifying management across various lines of business
- Solving complex insurance issues
- Having access to a strong and reliable global network
- Keeping up with changing regulatory frameworks, for example, Solvency II
- Providing accurate, transparent and timely bordereaux reporting through a single ceding party

Captive owner market strategies going forward

Owners of large captives may nowadays decide to increase the captive retention, as stated by the chairman of the German Risk Manager Association DVS in the September edition of the German insurance magazine *Versicherungswirtschaft*, which largely relates to German captive owners. Such owners might therefore use the infrastructure of the large insurance companies more in regards to their service capabilities than their capacities. We have seen the following reasons for a more active use of captives:

- to optimise insurance and reinsurance structures;
- to bring two worlds (life and non-life) into one reinsurance captive;
- to benefit from arbitrage opportunities in the markets (pricing, coverage and capacity);
- to strengthen the core business of the captive owner; and
- to develop new solutions for new risks

While the number of traditional insurers might become reduced and new capacity providers are entering the reinsurance and financial market, captive owners will likely try to increasingly unlock their arbitrage opportunities. Captives could thus be used more actively as a gate to the reinsurance and ILS market.

On the other hand, the amount of exposure reinsured to captives could substantially grow, especially with large 'gross cessions'. Fronting insurers need to manage the finance and insurance-related processes in a professional manner in order to avoid captive defaults. Insurance-related checks, which may include 'concurrency wording analysis', are of great importance in order to avoid wording differences between insurance and retrocession agreements.

Standardised referral process, insurance and financial related

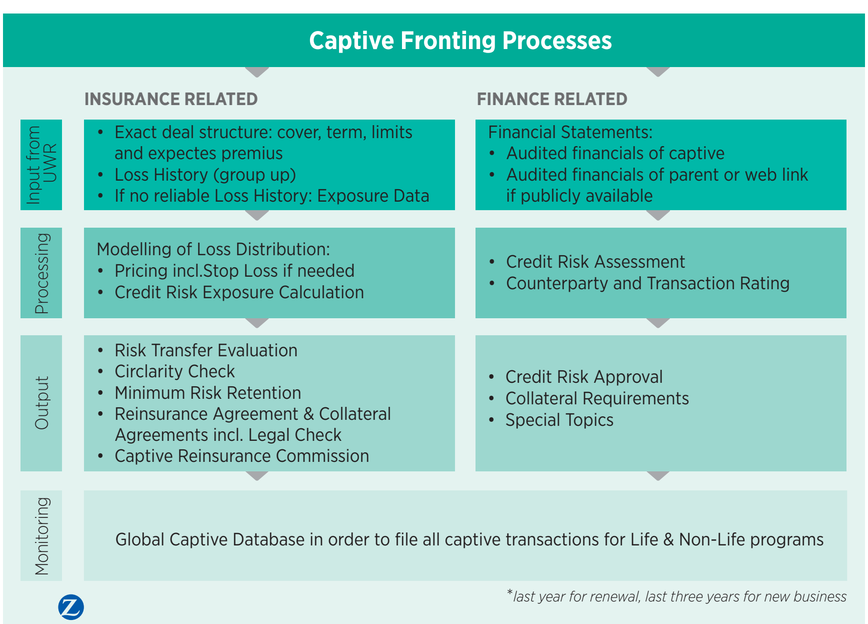
With regards to financial related checks, Zurich provides a flexible counterparty credit risk view by considering the rating from retrocessionaires (behind the captive) to the reinsurance level (Zurich to captive). Hence, a counterparty credit risk rating of a reinsurer behind the captive, which is better than the rating of the captive and/or of the captive parent, will help to mitigate potential collateral requirements on the reinsurance level. In this context, it can be noted that Zurich has not experienced any captive counterparty defaults in the last 20 years.

For Benelux captive owners, we have also observed an increasing interest in including employee benefit (EB) programmes, so as to diversify their captive portfolios and optimise their capital structure. Those EB captive programmes are mostly reinsured to captives on a proportional basis, often limited by a stop-loss for estimated cumulative losses occurring at the 95th percentile. This is a big business opportunity for various market participants, and such wide-ranging solutions require comprehensive captive expertise to ensure that the complex handling is not overly complicated. Sonia Cambier, global head of insurance & prevention at Solvay, agrees that there is increasing appetite in the Benelux economic union for captives to take on employee benefits risks. It is therefore no surprise that Solvay, too, have initiated a joint project with their HR department to implement minimum global cover levels worldwide with the support of their Luxembourg-domiciled captive.

Such holistic and international insurance programmes can be illustrated as in Figure 2.

Very often, captive customers request

FIG. 1 | CAPTIVE FRONTING PROCESSES



Source: Zurich

cross-class captive balance sheet solutions, to get protection for their non-life and life exposures.

Despite the continued softening market environment, captive owners are interested in exploring the terms and conditions of so-called multi-line protections, which can be extended from an annual limit to a multi-year scope in order to be prepared for an unexpected change in the insurance cycle.

Another benefit for a captive owner would be to receive consistent premium and claim bordereaux from a single source rather than from different regional reinsurance entities of the fronting insurer. A centralised clearinghouse is a powerful solution to meet such captive requirements.

Clearinghouse concepts also allow the use of one single captive reinsurance agreement for various programmes or lines of business. Furthermore, the monitoring of credit risk exposure and arm's length checks can be performed in a more efficient manner.

Finally, reinsurance premium payment processes, including advance and adjusted premium payments, and claim payments as well as reserving notes, will be simplified by the delivery of consistent captive bordereaux.

How captive owners could improve their claim management

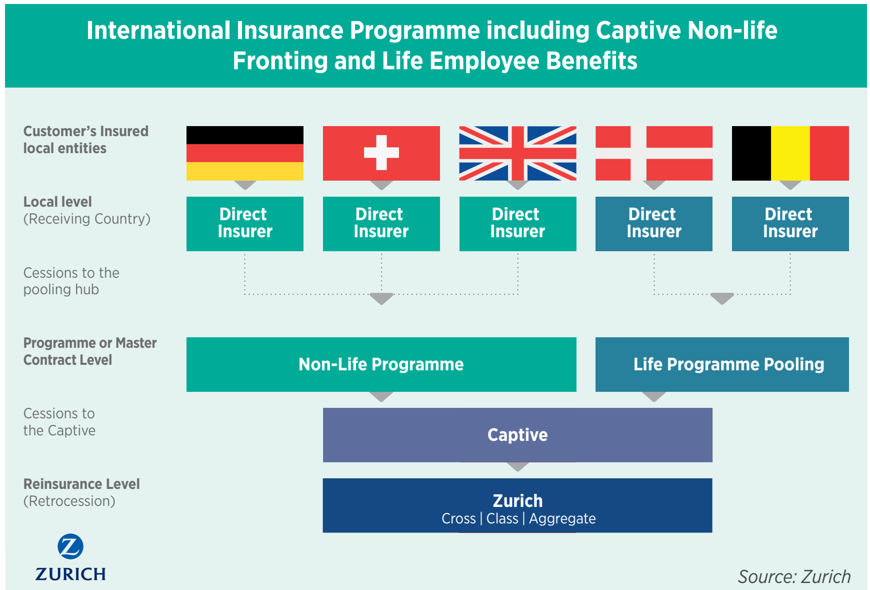
As earlier mentioned, risk assessment, control and mitigation advice should be at the core of every insurer's customer support. The ability to produce models using a blend of data from the customer's own experience, third parties and the insurer's own insights is vital to the successful management of risk.

At Zurich, we have 75 years of risk engineering experience and employ 800 risk engineering professionals worldwide with a broad range of industry expertise to take care of our customers' claims and risk prevention needs. The job is not done once a claim has been paid and working with our customers to consolidate global data in a consistent and reliable way, making relevant data available and working to reduce their cost of risk through analysing trends and producing forecasts, is a vital component.

We use 'MyZurich', a self-service platform which enables customers to access their risk information and claims data. The 'Global Claims Analytics' tool allows customers to generate risk insights, and can:

- help to monitor and act on risk management information. The tool supports the operational efficiency and strategic effectiveness of risk management.
- aggregate a real-time overview of your entire portfolio and drill into specific details for more informed decisions.
- give customers access to the complete claims history of their organisation, from a global overview down to specific claims details.
- manage risk improvement actions and track risk management history.
- integrate multiple data sources into an overall view of risk management from which risk managers are able to model different scenarios.

FIG. 2 | HOLISTIC CAPTIVE OWNER VIEW



Source: Zurich

> "Sonia Cambier, global head of insurance & prevention at Solvay, agrees that there is increasing appetite in the Benelux economic union for captives to take on employee benefits risks"

Summary

The Benelux insurance market for corporates provides various opportunities for captive owners for efficient risk transfer solutions. However, the variety of market choices has been reduced.

We have experienced that captive owners mostly consider four large lines of business for their reinsurance captive involvement: for non-life property, liability and marine, life, and employee benefit exposure.

Captive owners will likely explore their options with a view to concentrating the fronting business in the hands of one insurance provider, rather than having various fronting insurers in place, to limit the administrative costs of their insurance programme and captive reinsurance cessions. This is an important requirement in order to be well prepared for arbitrage strategies in the reinsurance and ILS markets.

Zurich is flexible to enable access to those strategic options and draws upon its comprehensive global experience on captive topics. Its network is available for captive owners.

Benelux captive owners are invited to approach us for further information.