CAPTIVES REDUCE THE STING OF P&C HARD MARKET

Written By Caroline McDonald

A market hardened by increased losses and claims ultimately leads to higher premiums for insurance buyers. When the rate of claims continues to rise due to factors such as environmental damage and legal issues, it can appear that there is no end in sight.

Global pricing for property insurance rose 7 percent in the third quarter of 2023 and 10 percent in each of the prior two quarters, according to Marsh's Global Insurance Market Index. In the US, property insurance pricing, on average, has risen for 24 consecutive quarters.

Marsh said several trends are influencing the property market. They include the high cost of reinsurance, which typically is passed on to policyholders by primary insurers, strong demand for limited capacity, ongoing losses and inflation of property values. Marsh noted:

In addition to raising their pricing, insurers are scrutinizing their property loss exposures and taking actions that include tightening terms and conditions, raising deductibles, and withdrawing capacity for loss-prone geographies. Capacity is particularly constrained in areas such as California, Florida, and Louisiana, but demand is growing as property owners continue to build facilities in the central US, where severe convective storm activity and other perils are increasing.

INSURANCE BUYERS SEEK RELIEF

Unable to foresee their premium expenses, property insurance buyers are left holding the bag. More and more organizations are entering the captive insurance market to protect themselves over the long term.

Also feeling the heat is the automotive market. According to Marsh, "The US automotive industry is now facing one of the most unpredictable and volatile trading environments in its history."

"The hard market is an area where performance by the insurance marketplace has not been great," said Jim DeWulf, executive vice president and captive executive at Captive Resources. "You're seeing price increases across the different layers of coverage. What we've tried to communicate to our groups is that inflation is a big piece of that – wages are up, and the cost of vehicles has risen."

Marsh said the auto industry is facing "pressure from federal and state regulators, growing concerns about vehicle emissions, domestic and overseas competition, competition in the mobility space, and the changing demands and expectations of consumers everywhere."

MAXIMIZING IMPACT

John Capasso, Chairman and CEO at Captive Planning Associates pointed out that a positive impact is that "Earnings on surplus are enhancing surplus because of higher rates of return. They are having better rates occurring on safe dollars, like bonds and CDs and money markets," he said.

The other side, he added, is that "You're seeing premium creep, even for programs that have been successful from claims and frequency perspectives. Everyone is getting hit. You're seeing markets hardening, especially property. That's been the case for the past two years or so."

Rate inflation, Capasso noted, "seems to affect everyone. It's incentivizing the CFOs of the C-suite and owners of businesses to be more aggressive with their captives, as far as taking on more risk."

To do this, Capasso said, they are raising deductibles "and taking on more layers within the towers, whether it's workers' comp, auto liability or specifically property."

Businesses, he said, more than ever have recognized the importance of minimizing risk. "We're seeing owners of businesses, CFOs of larger companies and even businesses with no risk management experience, turning to us to help them customize and take on risk management."

Capasso said they are also seeing people either terminating their micro captives or using them to write more commercial risks. "In some instances, they terminate them and start a new one for traditional P&C risk. They will shut down one and use the surplus to seed the new captive," he said.

DEALING WITH INFLATION

In some situations, Capasso said, "certain commercial carriers may have high claims and frequency and raise rates across the board to make up for the losses they are seeing in one particular book."

This is big, he said. "What impacts insurers will impact captives because, in many cases, captives are taking the first layer of insurance.

Rate inflation, Capasso said, is causing some self-insured groups, like group captives, to shut down. "We have two situations where these groups are being shut down because of regulators, leaving people scrambling."

They are being shut down because they are undercapitalized due to rate inflation, Capasso explained. “The rates go so high, and they don’t have enough capital to backstop the premium and the risk the backstop is assuming,” he said.

The goal is to strengthen captives, to help organizations deal with inflation. “If a car costs $25,000 today and it cost $20,000 last year, we have to make sure the captives have the appropriate funding to pay future losses,” DeWulf said.

On the claims side, Capasso said, is auto liability inflation. “The cost of vehicle repairs has skyrocketed because of labor costs and certain parts,” he said. “Today’s vehicles have electronic components and specialty metals. This is all leading to a significant price creep in inflation on repairs. It’s a domino effect and it forces carriers to increase rates.”

Capasso added, “We’ve actually seen some clients acquire auto body shops. That helps control costs because they can then do the repairs in-house.”

Over the past two to three years, DeWulf said, captives also have been able to raise their primary limit. “Our primary limit in the group used to be $1 million for auto and $1 million for general liability,” DeWulf said. “We have a significant number of captives now that used their size and the diversification of the captive portfolio to quote $2 million primary limits on auto and $2-$4 million on general liability.”

The advantage of a group, he said, is a vested interest in controlling losses. The result is much higher engagement in the group captive, “because you’re seeing all of the money, where it goes and how the spend is,” DeWulf said.

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STRENGTHS OF A CAPTIVE

As insurance companies, captives are as vulnerable to the effects of inflation as traditional insurers and reinsurers, said Robert P. Hartwig, clinical associate professor, Finance Department and director at the Center for Risk and Uncertainty Management at the Darla Moore School of Business, University of South Carolina.

Those vulnerabilities, Hartwig said, are:

Underinsurance: The replacement and repair costs for commercial properties may rise sharply during periods of unexpectedly high inflation. If captive managers have failed to appropriately account for higher property valuations, the captive can be exposed to great loss. This same problem has plagued traditional commercial property insurers over the past few years. Sometimes this is referred to as an insurance-to-value (ITV) problem. A similar situation can arise in commercial auto, with the separate problem of "social inflation" compounding the issue.

Reserve Inadequacy: Inflation can easily result in claim reserves established years ago becoming inadequate. Medical inflation was much lower than the overall inflation rate when inflation first took off in 2021-2022 but is now catching up. This trend could pressure workers' comp, general liability, medical professional liability, and other medical cost-sensitive exposures.

Reinsurance: Captives may find that their reinsurance limits are inadequate in an inflationary environment and should consider adjusting those limits appropriately based on an analysis of inflation's impact on the underlying exposures.

Hartwig explained that knowing these vulnerabilities, "can help organizations mitigate, though not avoid entirely, the issues arising from a sustained spike in inflation." This is the case, he said, "because the inflation was unanticipated, hence unknowable in advance, irrespective of whether you're a carrier or captive. But understanding the impacts on your captive can help you mitigate the consequences."

He concluded that the attractiveness of captives is enhanced during hard markets. "The current hard market has been in existence for some five years now, and many organizations have availed themselves of the captive structure over that time," Hartig explained. He added that a well-managed captive "can help an organization keep a lid on the cost of managing risk in the years ahead, which will likely continue to see a period of sustained rate increases."■

Caroline McDonald is an award-winning journalist who has reported on a wide variety of insurance topics. Her beat includes in-depth coverage of risk management and captives.