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## Emerging Global Challenges for Captives

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## 1. Introduction

Captives continue to provide an effective and flexible risk finance and management option, both for organisations that seek cross-border insurance coverage, and for those seeking to insure difficult-to-place risks. According to Strategic Risk Solutions, there were 6,647 captives globally in 2017, growth of 23% over the past decade (cell captives increase the worldwide number by an additional 3,000). 764 of the world's captives are domiciled in Europe.

Whereas captive insurance was once niche or unusual it has become a common and accepted form of alternative risk transfer over the past few decades. More than 90% of Fortune 500 businesses own at least one captive, while mid-sized companies are increasingly entering the captive business given reduced barriers to entry.

Three areas of particular interest for European captive owners at present are:

- » New exposures that can be insured optimally in captives as the insurance market develops;
- » Awareness of the increased scrutiny captives are receiving or likely to receive in the evolving regulatory environment, and
- » The essential capabilities that captive owners need to access in order to best manage their growing multinational insurance programmes.

One area where captive owners are looking to add value to their groups is by expanding the scope of risks they can manage. Growth in the captive market has historically been led through coverage of traditional lines of property and casualty business. But in more recent years captives have embraced the expansion into other lines - covering credit risks, environmental liability, employee benefits and longevity risk among others.

A growing number of captives are pushing the boundaries of what is insurable by looking at coverage for intangible risks, such as non-damage business interruption, cyber and reputational risks. There are a number of reasons driving this, including the benefits of diversification - particularly under Solvency II in Europe - and a current lack of suitable solutions for intangible risks in the commercial insurance market.

All this leads to the conclusion that the importance of comprehensive insurance has never been greater, particularly for a captive reinsuring multinational risks worldwide. Creating seamless coverage and a transparent, integrated global framework wherever possible is the benchmark for insuring, managing and servicing complex risks across national borders.



At Chubb, we believe captive owners must have the following five “pillars” on their checklist as they consider tomorrow’s multinational environment. An insurance partner committed to continued investment in these areas is best placed to support captive owners as their business and risk profile evolves:

- » People: Captive owners must demand a talented team with demonstrable in-depth experience as key to managing multinational risks in whatever form they might take;
- » Presence: Captives insuring risk across national borders especially in countries located in Africa, Asia and Latin America need the solid backing of a dependable insurance partner with a global presence;

- » Solutions: Captive clients need partners with the capability to craft solutions that fit an individual company’s profile, tailored precisely to its specific needs. To do this successfully requires a combination of core multinational lines and specialty multinational underwriting capability,
- » Technology: Captive owners must have the latest technology and an insurance partner that is willing to work with them to build digital capabilities that can manage their insurance programmes across time zones in real time, and
- » Service: When it really counts, it comes down to service. From risk engineering in emerging markets to claims settling across borders, having the right support is absolutely critical for companies if they are to manage complex multinational risks.

## 2. New and emerging exposures

Captive owners are continuing to expand coverage beyond traditional property and casualty risks, opening their risk retention vehicles up to specialist and emerging risks, such as environmental impairment liability, terrorism, cyber and even reputational risk. There are different drivers for this expansion.

Rising compliance and reporting costs and increased capital requirements have pushed captives further to evidence the value they provide. Leveraging their risk management expertise in traditional fields, captives are looking at a broader range of risks affecting their parent groups and seeking to add value by managing and mitigating these risks, while at the same time gaining a diversification benefit and utilising capital more efficiently. The involvement of captives in insuring new perils allows more flexibility and control over policy terms, such as exclusions, and claims management.

Much of this desire to self-insure new and emerging risks is also led by wider global changes affecting multinational groups. In an increasingly interconnected world, disruptions to supply chains and non-damage business interruption have become more of a concern. Meanwhile, the importance of intangible assets continues to rise - dubbed capitalism without capital - in a world where the largest global transportation company does not actually own any vehicles.

This has driven global corporates to look at how the perils that impact their intangible assets, such as reputational risk, may be managed and protected against. Large multinationals have

significant exposure to these types of risks and the commercial insurance industry is in the embryonic stages of finding solutions, thus putting the onus on captives to provide risk financing and “incubation” as these markets develop.

Damage to the brand and reputation is a major concern for risk managers. A negative incident (particularly when handled badly) can result in loss of revenue or destroy shareholder value. The scope for loss in today’s hyper-connected world is heightened, and with it, the need for swift remedial action and crisis communications to prevent a negative incident from spiralling out of control.

It’s important to remember that stakeholders in today’s public multinational companies are not just customers. Interested parties include institutional shareholders, employees, municipalities, regulators and the board of directors. This expanded group will ask “how have you anticipated and prepared for this event? Who will pay and how will any crisis be managed?”

Because accidents or unexpected events happen even to the best prepared businesses, companies should also make sure that they are adequately covered by a combination of local and global insurance programmes that responds to their potential exposures across the world. By taking a proactive approach to intangible risks and adequately insuring the exposures within their daily operations, businesses can better protect themselves in a complex and changing global operating environment.

## 2a. Responding to rising environmental risk

Changes in regulations and increased penalties and remedial costs have heightened awareness around Environmental Impairment Liability (EIL). According to the World Economic Forum's Global Risks Report 2018, man-made environmental disasters are listed as a top 10 risk in terms of likelihood. Environmental risk is a material risk for a company, affecting both operational ability as well as reputation when the organisation fails to plan for it properly.

But it is also a global risk. When operating on a multinational basis, businesses face a unique set of risks with differing exposures across multiple jurisdictions, and an event that occurs in one country can have knock-on effect to that organisation's global operations.

With the costs - financial and reputational - of dealing with such disasters on the rise, Chubb has seen an increase in the use of captives reinsuring multinational EIL programmes over the last five years. Captive owners are increasingly looking for tailor-made coverage for their exposures in mature and emerging market countries.

While a petrochemical company has obvious exposures, today any company that owns, uses, buys or sells property; operates on third-party premises; or uses, stores or transports a substance that may cause contamination is at risk. Moreover, there is a trend in several markets including Argentina, Australia, China, the EU and India for regulators to hold senior executives personally responsible for their company's failures in this area.

For these complex risks, specialist local EIL insurance capabilities are more than just about a policy wording and financial strength. A credible and sustainable solution will also help to promote good corporate responsibility and manage complex risks. It should include consultative expertise for pre- and post-loss event management, and responsibly mitigate any adverse impact on reputation anywhere in the world.

Companies may not realise that pollution liabilities arising out of their daily operations will not be covered by traditional general liability and property insurance programmes, which often include pollution exclusions. To protect their investments, companies need to consider EIL policies that include premises pollution cover as well as third-party liability cover for losses incurred as a consequence of on-site incidents. Companies may also want to consider purchasing an insurance product that provides expert help in a crisis to manage any resulting threat to their reputation.

At Chubb we have found there is considerable confusion among many companies as to whether or not and to what extent environmental risks are covered by their existing insurance programmes. In many cases businesses think they are covered when this is not the case. EIL insurance, which absorbs the financial costs associated with cleaning up accidental spills or leaks of pollutants, can address the coverage gaps created by the pollution exclusions in general liability, property, and D&O liability insurance products.

## 2b. When cyber captives make sense

Many businesses are still learning about their potential liabilities arising from a data breach or the impact of a cyber business interruption. A recent UK Risk Management Association (AIRMIC) survey indicates that over half of the risk managers surveyed do not currently have insurance for cyber-related crimes even though few companies or industries are immune from an attack, and that damage to a company's reputation is often a by-product.

Today, the global nature of this risk is undeniable. The issue is also one of regional importance as the European Union introduces new Cyber Directives; legislation which expands jurisdictional oversight to where and with whom the company conducts business.

Managing cyber risk within a captive is increasingly becoming relevant for multinational companies that find a combination of risk transfer and risk retention meaningful. An experienced cyber underwriter—in addition to an insurer with captive capabilities—to underwrite and engineer cyber risks is essential to cyber multinational programmes. Today, the current trend is for captives to retain the first party and third party coverages for adequate, yet relatively manageable, premium. In addition, carving out the local policy deductible and reimbursing it under the captive programme is also a meaningful solution.

Buyers must recognise the complex multinational capabilities that are unique to cyber. Cyber crosses both first and third party risk, impacting both property and casualty exposures in local territories. Partnering with a carrier that makes sure that buyers have like for like cover in all territories can ensure that coverage certainty is maintained and there is the ability to pay into territories when the (likely) global cyber incident impacts the company.

A prudent multinational insurance programme should include provision for reputation management and PR costs in a crisis. A full enterprise risk management approach should also include benchmarking before a policy is bound, supported by detailed risk engineering surveys that suggest measures to reduce the risks of breaches or attacks and enhance vigilance and preparedness generally. This can be achieved with the support of the right external partners.

As part of the multinational claims process it is critical to track key metrics, such as actions causing a cyber loss, whether a cyber incident was caused by an internal or external actor, the number of impacted records etc. This data allows captive managers to build programmes at affordable prices while getting the service value, scale and expertise of a global insurer's local capabilities.

Using a captive to participate in cyber risk management can also provide more comprehensive cover for the parent company than is available in the commercial insurance market. Often, this is done with a view to 'incubating' the risks, gathering data and understanding the exposure over a number of years so that an insurer or reinsurer will thereafter be able to take on the risk at an appropriate limit and premium.

Even if a captive is only seeking to 'incubate' such risks for a short time, captive managers will need to take care to ensure that from their own solvency and governance perspective they are able to underwrite these risks themselves. As cyber risk data becomes more credible, captives can make better-informed decisions about their global exposures.

### 3. Navigating a complex regulatory environment

Captives need to understand and be able to adapt to the ever-changing insurance requirements affecting them, their insurance partners and their reinsurers. The cross-border nature of most captives means that they are faced with an increasing compliance burden that reflects the tightening of insurance regulatory requirements across the globe, as well as other local legal requirements, such as in relation to data privacy.

These requirements relate not just to where the captive is based but to where its underlying risks or staff and service providers may be located. Local prudential requirements on insurers and administration and distribution rules can apply to captives and, where captives may be writing business directly in jurisdictions that permit non-admitted insurance, care is required to continue to avoid being brought on-shore for regulatory purposes.

For the European captive market, Solvency II significantly impacted capital and solvency requirements, as well as governance arrangements for captives. Whilst these prudential capital requirements are now more settled, in many European jurisdictions governance requirements and responsibilities of management continue to be under the spotlight. Other European regulations continue to evolve, with the recent implementation of the Insurance Distribution Directive changing and strengthening requirements relating to product terms and distribution.

Globally, changing prudential or solvency standards have wide-ranging implications for captives. Primarily, changes in a captive's home jurisdiction may require captives to re-structure their outwards reinsurance programmes and collateral arrangements to ensure

they receive appropriate capital relief. This is certainly true for Luxembourg and Dublin, two captive centres in Europe and thus subject to the Solvency II regime. However, changes in capital requirements in other jurisdictions may impact the retention requirements of local policy-issuing insurers in multinational programmes, or in the collateral or other security they may require from a captive.

Outside insurance regulation, the use of customer data, and protection of that data from cyber attacks and other unlawful disclosure, is under increasing scrutiny across the world. In Europe, the General Data Protection Regulations (GDPR) has introduced strict data breach notification requirements and steep financial penalties for non-compliance. Captives need to be aware of and ensure they comply with GDPR and other tightening data privacy laws around the globe.

For captives operating in the UK, Brexit will likely have implications, whether business is currently written directly into the UK under passporting rights, and/or whether it has staff or other service providers based in the UK. New fronting arrangements may be required, a third country branch may be necessary or the activities may need to be restructured to ensure no regulated activities are carried out in the UK.

This rich and ever-changing regulatory landscape requires captives to understand and manage their compliance risks in order to avoid fines, increased costs and reputational damage. Having the right insurance partner alongside you who is willing and able to work with you to foresee, understand, adapt to and manage the impact of these regulatory changes is key, particularly when structuring a multinational insurance programme.

### 4. An emphasis on transparent service standards

Captives must prioritise transparency of documentation and cash flow - two increasingly important themes for an effective multinational captive insurance programme - in today's increasingly complex compliance environment.

There are large discrepancies between different local insurance regulations and laws. Some like South Korea and the Philippines, require the local insured or broker to disclose tax information to the regulator before a local policy can be issued and premium collected. Some, for example, India and Japan, are 'cash before cover' and in others, such as Brazil and Chile, a firm order or application form must be completed by the local subsidiary before a local policy can be issued.

A key takeaway for a captive owner is that the thoroughness with which they respond to local rules will ultimately determine the timeliness of local policies being issued, local premiums being collected, local taxes being remitted, and permitted premiums being ceded to the captive. Compliance with local insurance rules is therefore an important aspect of the overall performance of their global captive insurance programme.

Another area where transparency is often particularly important is cash flow. Since premiums are paid in different countries, the funds that are eventually remitted to the captive may be impacted by a number of factors, such as in India, where a local insurer has to exhaust the local market for reinsurance before offering it overseas; when the local country has a 'premium withheld' obligation, or when there is a restriction on the export of local risks. An example is CIMA, the 14 sub-Saharan French speaking countries\*, with new exportability rules for risks incepting on or after 1 June 2016. Other than lines such as motor liability that are excluded from cessions, risk cessions outside

the CIMA zone are limited to 50%, unless the local insurer can get special authorisation from the national regulator (by policy). An ability to access up-to-date and relevant laws regarding cash flows is increasingly critical for a captive owner in today's globalised marketplace.

Transparency is also needed in the effective handling of multinational claims and loss reporting. Robust claims-servicing agreements with agreed claims bulletins, claims protocols, claims procedures, and transparent servicing standards - with identified local and central points of contact - is key to managing both communication with and the expectations of those who are handling complex claims, often many thousands of miles from where ultimate decision-making may lie.

The best claim results are those where the insurer, broker, captive manager/risk manager, and the insured's finance and tax team work collaboratively to understand how and where insurance will respond. Understanding how third-party administrators and adjusters, if applicable, will work with a partner insurer to adjust and value claims is a further factor that underlines the importance of effective claims management for a captive insurer.

When it comes to loss reporting, captives often insure primary layers where loss activity may be frequent. Consequently, the quality of the loss-data is paramount, not only for accounting purposes, but also for the risk management analyses regularly performed by the captive manager. When choosing a global insurance partner or broker whose IT systems may be used to manage international claims, captive owners should look for those with sophisticated capabilities to gather analyse and share loss data and trends.

“ The right global insurance partner can deliver transparent service standards that secure operational efficiency, and can address and comply with local insurance regulations and laws ”

\* CIMA countries; Benin, Burkina Faso, Central African Republic, Chad, Comoros, Congo (Republic of), Equatorial Guinea, Gabon, Guinea Bissau, Ivory Coast, Mali, Niger, Senegal and Togo.

## 5. Conclusion

“ Ultimately, it is simpler to manage a global insurance programme with the assistance of a single, coordinated, global insurance partner. This is particularly pertinent in the face of growing demand for innovative insurance solutions that address new risk classes and new markets ”

Captives remain a highly-effective and versatile alternative and/or complement to traditional risk transfer options. They are an obvious choice for multinational companies with established risk management programmes, a longstanding commitment to loss control, and/or difficult-to-place risks in addition to those seeking to insure exposures that are not readily insurable in the traditional insurance market.

For these large corporations, captives provide improved net cash flow from investment income, potential tax benefits, flexibility, increased control, and access to reinsurance market capacity, as well as access to insurance coverage and services for emerging risks. As discussed, a growing number of captives are broadening the scope of their traditional property & casualty captive programmes, to include coverage for specialist risks, such as cyber and environmental liability.

Captive owners should periodically evaluate the capabilities and limitations of their captive insurance partners. When choosing a global insurance partner, a captive owner should assess whether their partner can provide a robust ‘owned’ global network, provide a suite of sophisticated insurance solutions and has proven expertise in delivering compliant multinational insurance programmes.

With foresight, planning and expertise, captive insurance solutions can be designed to insure and manage ever-more complex risks as globalisation adds further layers of complexity.



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