The Silver Lining of a Hardening Market: NextGen Risk Finance Is Here

October 2019

Empower Results®

Introduction

In the 3rd quarter of 2018 our Global Construction & Infrastructure Group issued a paper titled "The Many Strategic Roles of a Construction Captive." In that paper we outlined seven strategic roles a captive can play within the global construction industry, including allowing more control over insurance pricing and capacity shocks. Since issuing that paper, several key insurance lines associated with the construction sector have undergone mild to moderate firming (evidenced by higher pricing and reduced coverage). In this article, we spotlight not only how captives are being deployed to mitigate the impact of the hardening market, but also how data and analytics are changing the narrative around captives and how they are assessed and leveraged by companies through all market conditions.

Major losses from extreme weather events, rising jury awards, and an increased frequency of severe liability losses are among the forces shrinking the supply of traditional insurance and driving up rates. The construction sector in particular has seen significant lost capacity in professional liability, as well as construction property and casualty covers. In addition, we continue to see firmness within the subcontractor default insurance market place. (For more detail on the global firming of the construction market place, see our recent Construction & Infrastructure Global Market Update.)

Taking Cover in Captives

In this environment, we've been seeing captives more aggressively deployed for construction contractors in various ways. They are coming into play across numerous lines – for both OCIPs and CCIPs, and encompassing Builder's Risk, Workers' Comp and GL as well as Subcontractor Default. Captives are increasingly housing homebuilder's completed operations warranties.

As the market tightens, construction firms are using captives to take higher retentions. They are allowing firms to ventilate capacity and plug holes in insurance towers – at both primary and excess levels - where capacity is short or prohibitively expensive.

Some firms facing significant price increases, retentions and restrictive limits resulting from large natural catastrophe exposures have moved these risks into protected cell companies. In another notable trend, rather than primary retentions being set based on individual risk lines, a uniform, higher retention is being taken by the captive across multiple lines, with aggregate stop-loss cover purchased in the reinsurance market. Captives are also being used in multi-layered global programs to ensure broader insurance availability in all the countries where a company does business. There is a distinct movement towards "portfolio" approaches where the emphasis is both on managing line of coverage cost and overall risk portfolio volatility.

The key benefits of deploying captives in these ways include to combat unbudgeted price increases, maintain program control, and facilitate access to reinsurance market capacity that would otherwise be unavailable.

Same Captives, New Conversations

Using captives to weather a hardening market is nothing new. What is different is that we now have a wealth of data and analytics on insurance risk, pricing and losses that we did not have five or ten years ago. Leveraging this data, we are able to transform the way captives are assessed, evaluated and deployed. Taking a cue from the worlds of economics and investments, we are able to understand the efficient frontier – and identify the strike price -- where a captive makes financial sense when compared to what the traditional market is offering.

Rather than “retreating” to captives to escape a hard market, there is a shift in mind-set: Captives are the “underwriter of choice” when the math points to it, and an economical aggregate underwriting tool.

Far beyond a hard market refuge, the captive is a locus for activity that goes hand in hand with a company’s profitability. As conditions and competition for profitable business evolve, captive participation can be scaled back or tailored at renewal. And with the data we’ve accumulated, these decisions are made with new precision and transparency.

Behavioral economics combined with behavioural safety are coming into play: Our wealth of data enables companies to see trends; and indentify behaviours that are impacting the economics of their business. Such information can be considered in the risk finance narrative and companies can make well-informed decisions about where to invest in loss control and risk management.

Adding Innovation to the Captive Equation

Typically, in the past, we have structured captives with three committees, including:

- underwriting, which does the math and pricing;
- investing, to maximize return on premiums paid to the captive; and
- claims, focusing on the loss control, safety and behavioural issues as well as processing claims.

Today, indicative of the new philosophy around captives, we include a fourth committee, focused on innovation. This Innovation Committee is constantly seeking ways to use the captive as an innovation tool – it fields questions, solves problems and focuses on adding value by enhancing profitability.

NextGen Risk Finance

As the market continues to firm and capacity for key property, casualty, professional liability and performance security lines continue to recede, we expect more insureds to be dusting off their captives or creating new ones to generate desired capacity and terms around the globe.

Now, though, they have new, data-driven ways to enhance transparency and understand the economics of a captive versus the market place -- and the information they need to recognize “the underwriter of choice” – be it a captive or otherwise, hard market or soft.

Contacts

Ward Ching
Managing Director
Captive & Insurance Management
Aon Global Risk Consulting
t +1.415.486.7430
ward.ching@aon.com

Brenda Reddick
Director and Actuary
Aon Global Risk Consulting
t + 1.952.807.0684
brenda.reddick@aon.com

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information on our capabilities and to learn how we empower results for clients, please visit aon.mediaroom.com.

www.aon.com

Empower Results®