Navigating the Soft Insurance Market: Strategies for Captive Owners and Insurers

Alex Wright

All the current trends point towards a soft insurance market.

Premiums are stabilizing or falling, terms of coverage are becoming broader, capacity is increasing, higher liability limits are becoming available, access is easier to excess liability layers, and competition among insurers is intensifying.

But from a captive insurance company's perspective, how do you identify when a soft market cycle is approaching and get ahead of the curve to mitigate the potential risks and capitalize on the opportunities it may present?

Insurers moving back into or expanding in areas of the market where they had previously withdrawn or limited their cover in is a clear indicator that a soft market is coming, according to Amy Evans, executive vice president, liability claims division at Intercare Insurance Services. Having ongoing discussions with insurer partners can help to detect these shifts, she said.

Ms. Evans said that the soft market can have a profound effect on captives' claims management strategies and practices. Some captive owners may decide to move away from their captive when low premiums driven by the soft market become enticing and maintaining engagement with those who are still involved in claims and lawsuits can be a challenge, she said.

"We encourage captive owners to maintain strong policy language, requiring a duty to cooperate as a condition of coverage," said Ms. Evans. "We also recommend that the captive board maintain the right to consent to settle so that the captive retains control of its losses."

There are several steps that captive owners can take to mitigate against the onset of a soft market, said Ms. Evans. Chief among them, she said, is to plan for the potential departure of captive members.

Another strategy, said Ms. Evans, is to consider redomiciling your captive to protect against a soft market. Some captive owners have already taken the plunge, she said.

"The driving factor appears to be cost savings," said Ms. Evans. "Secondarily, we have seen clients consider redomiciling due to challenges with domicile examinations. Concerns appear to be inexperienced auditors, lengthy exams and extensive costs."

Ms. Evans said that captive owners should also consider engaging the parent company's senior leadership to ensure everyone is aligned on the captive's purpose. That includes discussing the risks the parent wants to maintain within the captive and the risk that should be placed in the commercial market, she said.

The Commercial Insurer's Role

Commercial insurers can also help captive owners recognize when the market is shifting by presenting a holistic view of how the cycle has changed and what is driving it, said Jennifer Guidry, divisional vice president—business development and marketing, Alternative Markets, at Great American Insurance Group. An example of this, she said, is that, with the US general election looming and growing geopolitical concerns, this could result in increased cyber threats and harm, which, in turn, would have a systemic impact on the cyber-insurance market and rates, she said.

"As part of their mutual interest of the relationship between the commercial insurer and the captive insurer, it is important to have an aligned vision that is well thought out and articulated that identifies potential disruptions before they happen," said Ms. Guidry. "At the commencement of the relationship, going through a simple [strengths, weaknesses, opportunities, and threats (SWOT)] analysis and lasering in on market cycle changes could help support a discussion that brings to light potential disrupters in the near future but also aims to find both short-term tactical and long-term strategies to minimize or mitigate disruptions once a soft market cycle ensues.

"In addition, a way to mitigate potential disruptions is direct communication from the commercial insurer to the captive insurer on what market signals are trending by line of business, irrespective of whether the line of business is in the captive or not. For example, if there is softening capacity in a supporting line outside of the captive, does it make sense to bring that line into the captive to continue to strengthen already good results or improve existing results?"

With every expense likely to be questioned harder in a soft market, it's also critical for the commercial insurer, third-party administrator, and other service providers to ensure they take a proactive stance in ensuring all dollars allocated to them are tied to a value proposition that is tangible and regularly communicated and understood, said Ms. Guidry. Innovation is paramount too, she said.

"Successful captive insurers and commercial insurers who have joined together and stood the test of time are not only thinking about how do they get stronger but the new ways in which they can gain additional momentum; whether it be through expanding the captive into new product lines, structuring it differently, or negotiating better terms and conditions."

To smooth the ebbs and flows of the market cycle, a captive should be used as a risk finance tool, said David Beyer, director, risk management at Alaska Airlines. While using a commercial insurer to cover the risks previously insured by the captive may seem attractive in a soft market, he said that, in reality, moving insurance lines between the captive and insurer can prolong the cycle.

"The exercise of moving insurance lines in and out of the captive to chase lower rates during market cycles will only help to further the market cycles and limit the chance at achieving the goal of the captive," said Mr. Beyer.#"To achieve the goal it may be better to restructure lines into a quota share program.#Transfer portions out to achieve rate reductions, while retaining portions to help smooth the overall market cycle."

Among the actions captive owners can take to weather a soft market, Mr. Beyer said, are dormancy, consolidation, and restructuring. Another option is to develop and incubate new policy lines and prove their viability to the commercial market, he said.

Consequences of Failing To Prepare

Failure to prepare for a soft market, said Marcy Van Stee, director, business development at Riverstone, may mean that captive owners' profit margins are squeezed by increased competition from traditional insurers. Additionally, she said that captives could quickly lose market share if they aren't equipped with the necessary tools or strategies to compete.

Added to that, Ms. Van Stee said, in soft markets insurers tend to accept risk they may not ordinarily take on in harder markets. While captive owners may find it tempting to slash premiums and reduce underwriting requirements in an attempt to remain competitive and retain members, these measures may ultimately increase long-term risks affecting the business for years to come.

A soft market may also usher new regulatory standards and requirements, ranging from pricing guidelines to risk management procedures, said Ms. Van Stee. Those captive owners who aren't prepared could be caught off-guard and risk noncompliance, which could result in penalties, reputational damage, and, in extreme cases, losing their operating license, she said.

"Changing regulations can necessitate alterations to business models and strategies, requiring a level of operational flexibility that some captives may not possess," said Ms. Van Stee. "If not anticipated and planned for, these changes can disrupt operations, creating inefficiencies and potentially leading to financial losses."

Operationally, Ms. Van Stee said that, faced by increased competition and low premiums, captive owners may find themselves pressed to streamline operations and cut costs, while trying to continue to maintain high service levels. That could involve restructuring teams, adopting new technologies, or outsourcing certain functions, all of which can pose significant challenges if not managed effectively, she said.

"Captive owners who attempt to increase their volume of policies written by implementing looser underwriting standards could see an uptick in claims," said Ms. Van Stee. "If a captive's claims handling processes are not robust, this could lead to delays, customer dissatisfaction, and, ultimately, financial losses."

A soft market can lead to complacency in terms of risk management too, said Ms. Van Stee. Lower premiums can make captive owners less vigilant about controlling losses, which could have long-term financial consequences, she said.

"Preparing for a soft market cycle involves diligent planning, keen risk management, and strategic decision-making," said Ms. Van Stee. "Captive owners who neglect these aspects might find themselves facing challenges that could have been mitigated or avoided altogether."

While consolidation, dormancy, and redomiciliation are all strategies worth exploring during a soft market, more proactive approaches focused on shedding existing liabilities may prove worthwhile as well. In terms of these solutions, Ms. Van Stee said that loss portfolio transfers (LPTs) may enable captive owners to stabilize their operations by transferring risks originally written during a harder market to a reinsurer, turning the soft market to their advantage by taking advantage of a more affordable reinsurance market. That both frees up much-needed capital and reduces volatility in their financial results, she added.

"By leveraging LPTs, captives can focus on writing new, more profitable business, while the reinsurer takes care of the legacy liabilities," said Ms. Van Stee. "This ability to 'clean the slate' can be especially beneficial during a soft market cycle, where the focus is on competitive pricing and underwriting profitability."

Another key advantage of LPTs, said Ms. Van Stee, is the ability to shed long-tail liabilities, which often require substantial reserves, tying up capital that could otherwise be used more productively. Retaining these liabilities through a soft market cycle potentially introduces significant uncertainty into an insurer's financial projections due to the time lag between when the policy is sold and when a claim is made, she said.

"LPTs may present an effective solution to these challenges," said Ms. Van Stee. "By transferring these long-tail liabilities to a reinsurer, captive insurers may mitigate uncertainty and release reserves tied up in these policies. This is particularly beneficial in a soft market, where capital efficiency and financial stability can provide a competitive edge."

Alex Wright
Freelance Business Journalist
alex@alexwrightcopywriter.com

Mr. Wright is a freelance business journalist, specializing in insurance. He has been deputy business editor at the Royal Gazette in Bermuda, and news editor at Insurance Times and Global Reinsurance. He also writes regularly for Risk & Insurance and International Risk Management Institute, Inc.