



## Mancini's Musings from VCIA 2011 -- Captive Insurance Resilience in a Chaotic Economy: Fantasy or Reality?

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During the 2011 VCIA Conference, I had the pleasure of chatting for a few moments with a long time friend and colleague from Towers Watson, Jim Swanke, about his perceptions of the captive insurance market.

It seems clear that for the last several years, few would argue that the global economy has been far from robust. Formerly-strong currencies are losing strength. Investment options are few. Economic, political, and social uncertainties dominate the landscape on both sides of the pond. The August 2011 debt ceiling debate in the US, excessive government spending in many free-market countries, and the violent stock market fluctuations dominated discussions at the conference. Regulatory overreach on both sides of the pond was a popular cocktail party and dinner topic too.

Despite this chaos, exacerbated by a soft market that has persisted for years, the captive insurance industry has more than held its own – and is even flourishing! I asked Jim what he makes of all this, and where he sees the captive insurance industry heading down the road. Jim smiled broadly, and stated emphatically, “Of all my years in captives, this is the most robust period ever. Many believe that the soft market is about to end. Catastrophes, reinsurance prices -- all the pointers suggest a hard market is on the way.”

Property rates are firm, and there is even some firming in the casualty area. In large corporations that own captives, re-engineering of those captives is already taking place. Captive owners are regularly asking themselves and their consultants, “How can we use our captives more efficiently?” and “Are there uses for our captives that we hadn’t considered in the past?”

A good example of the reengineering that Jim is seeing is in the introduction of gross line captives. In this structure, the companies optimize the amount of risk they send out of the captive, and are therefore in a better position to assess such questions as: What is the catastrophic risk? What is the risk we should be sending out into the market?

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Swanke added that new uses for captives have spurred captive consulting companies to develop new generations of innovative analytical tools. One such example is Towers Watson's use of a "cost of capital" approach, where insurance and reinsurance products are analyzed to determine the implied cost of capital charge for the product. In this way, an insured can decide whether or not they are getting a good deal! Jim explained, "If the implied cost of capital charge is higher than their weighted average cost of capital, then greater risk retention could well be a logical choice. In this economy where many corporations are sitting on large amounts of cash, such thinking makes good sense in assessing the desirability of greater risk retention levels." In the likely event that the market does harden over the next 12 months, such strategies will become increasingly beneficial. Towers Watson offers several analytical and software solutions to help companies think through such decision making processes - <http://www.towerswatson.com/services/Corporate-Risk-Advisory-and-Brokerage>

Over the last few years, captive.com has learned from numerous service providers and regulatory sources that captives are increasingly being used for far more than hazard risks. Jim agreed wholeheartedly. "In the last week, we have had discussions with companies that want to put benefits, financial risk, and more, in captives." He added, "For example, a food processing company is looking to cover its basis risk from their commodity transactions within their captive. The activity for new uses of captives has never been at this level."

Feasibility studies being done for new captive uses have resulted in robust captive growth during these ghastly economic times. In 1981, 30 years ago, the industry had licensed approximately 1,200 captives; today, there are 5,400 estimated operating captives worldwide. These numbers are remarkable by any standards, and show no signs of slowing. Au contraire!

With captives increasing, what about self-insured entities? What's happening there? Our contacts confirm that the industry is also seeing an enormous increase in corporations large and small, as well as government entities, self-insuring their risks. What is Towers Watson experiencing first hand? Jim reports seeing approximately equal growth of captives and self-insured entities. "The \$100,000 annual cost for a captive needs to be justified in order to set up a captive; self-insurance features lower initial and ongoing costs," he said. "However, self-insurance is run through the balance sheet of the corporation, whereas the captive's insurance is not. The captive is stable through hard and soft markets, so loss control is more predictable. If a company can't achieve any economic advantage through forming a captive, though, such formation is certainly not warranted."

So, where are we heading in the coming years? Jim closed with this thought, "For a young person in a university getting a risk and insurance degree – perhaps including an MBA in finance – the next 20 years will be an exciting time indeed. Buckle your seatbelt; you are in for an amazing ride."

At the close of our discussion, it occurred to me that I hadn't asked Jim about his current title at Towers Watson. Jim's reply? "My formal title is Director of Risk Consulting, but you can call me anything you want. My wife does." A man after my own heart!