SOUTH CAROLINA CAPTIVE INSURANCE ASSOCIATION
20TH ANNUAL EXECUTIVE EDUCATIONAL CONFERENCE

Remarks by W. Jay Branum

Director of Captives at the South Carolina Department of Insurance

September 11, 2019

I. Introduction

Thank you, Meghan, and thank all of you out there for coming to our conference. It is very gratifying to see so many of you returning to South Carolina year after year eager to hear the country's top captive experts share their knowledge and insights with all of us and with each other.

Our speakers have many domicile conferences to choose from (both in the U.S. and abroad), just as all you captive owners have many domiciles to choose from – *too many*, really. In fact, I am reminded of what Winston Churchill said of his political rival Clement Atlee, who served as PM from 1945 to 1951. Churchill called him *"a modest man with a great deal to be modest about*".[1]

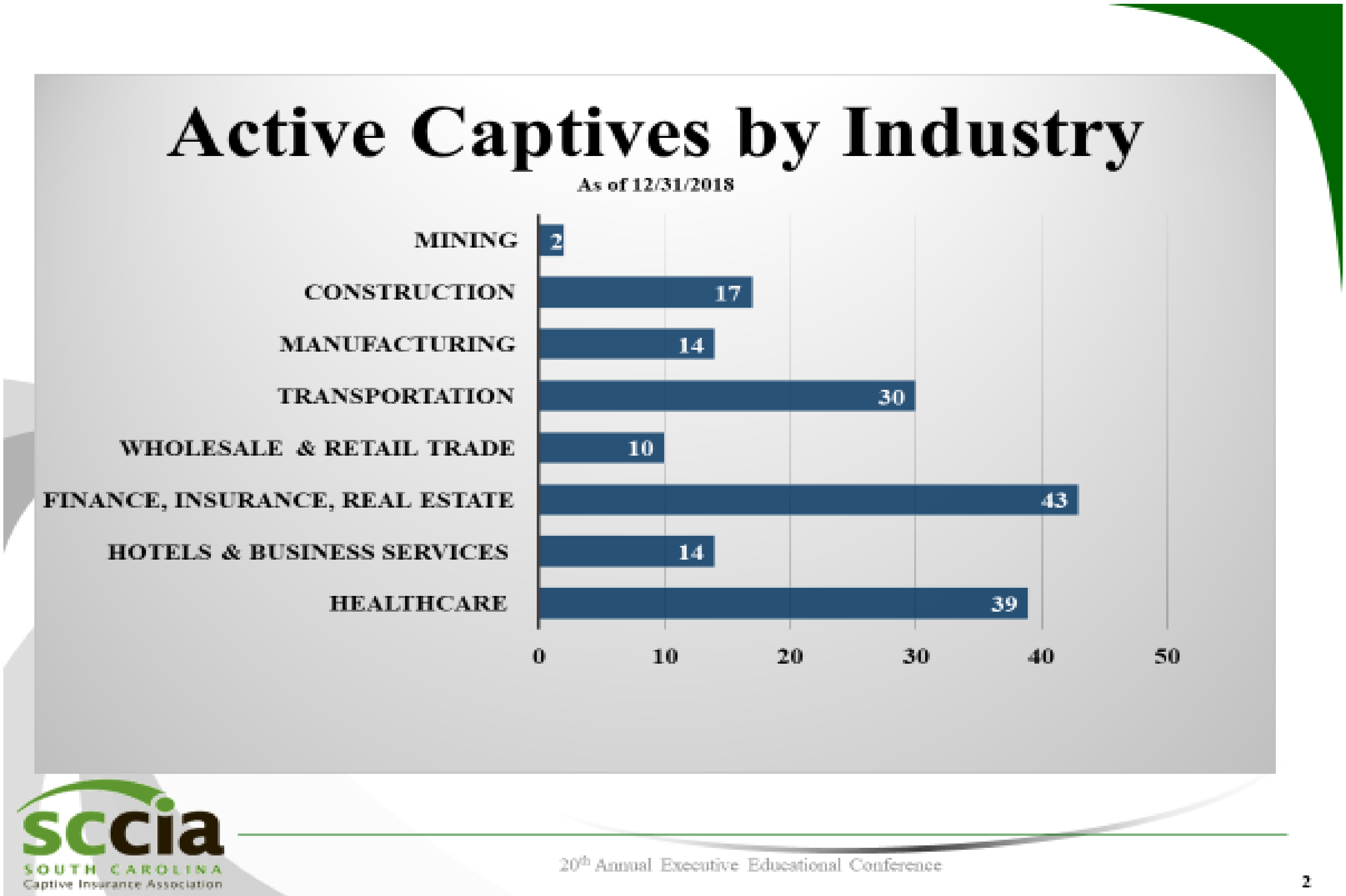
When you look at a map of the United States with all the captive domicile states colored in, it is hard to escape the conclusion that the great majority of onshore captive domiciles can rightly be called "modest" domiciles, and indeed most of them have a great deal to be modest about. A fair number of them are no more than "virtual" domiciles – states with enabling legislation on their statute books, but no investment by the state and little if any traction in building a captive portfolio or a foundation of captive-specific knowledge and experience on the basis of which to attract the business.

There is simply no reason to believe that more than a few U.S.-based domiciles will ever make the *ongoing investments* needed to achieve what any of us would regard as "critical mass" and thus earn a secure place among the more established and committed domiciles. A bit of humility is only appropriate for those jurisdictions with a low level of resource investment in captives at the DOI level, a low level of investment in in-state capabilities on the part of captive practitioners and stakeholders, and a low level of practical experience informed by a well-rounded business perspective specific to the captive sector. And make no mistake: it takes a sustained investment approach over an appreciable period of time for any state to achieve credibility as a member of the small circle of leading onshore captive domiciles.

Clearly, the captive marketplace in the United States today has an over-abundance of domiciles with modest attainments and modest, if not bleak, prospects. In contrast to all those domiciles, here in the Palmetto State we have a great deal to be *proud* about, and on this occasion of the opening of our 20th annual conference, I think it entirely fitting for us to celebrate our virtues and accomplishments not merely as a well-established domicile, but also as one of the world's leading captive domiciles with a growing reputation for thought leadership and an enviable concentration of seasoned captive experts from a range of professional disciplines living and working right here in our state. This fact alone – the presence of a bona fide community of captive service professionals from all the relevant disciplines based right here in South Carolina – sets us apart from every other onshore domicile not renowned for maple syrup, ski slopes, and fall foliage.

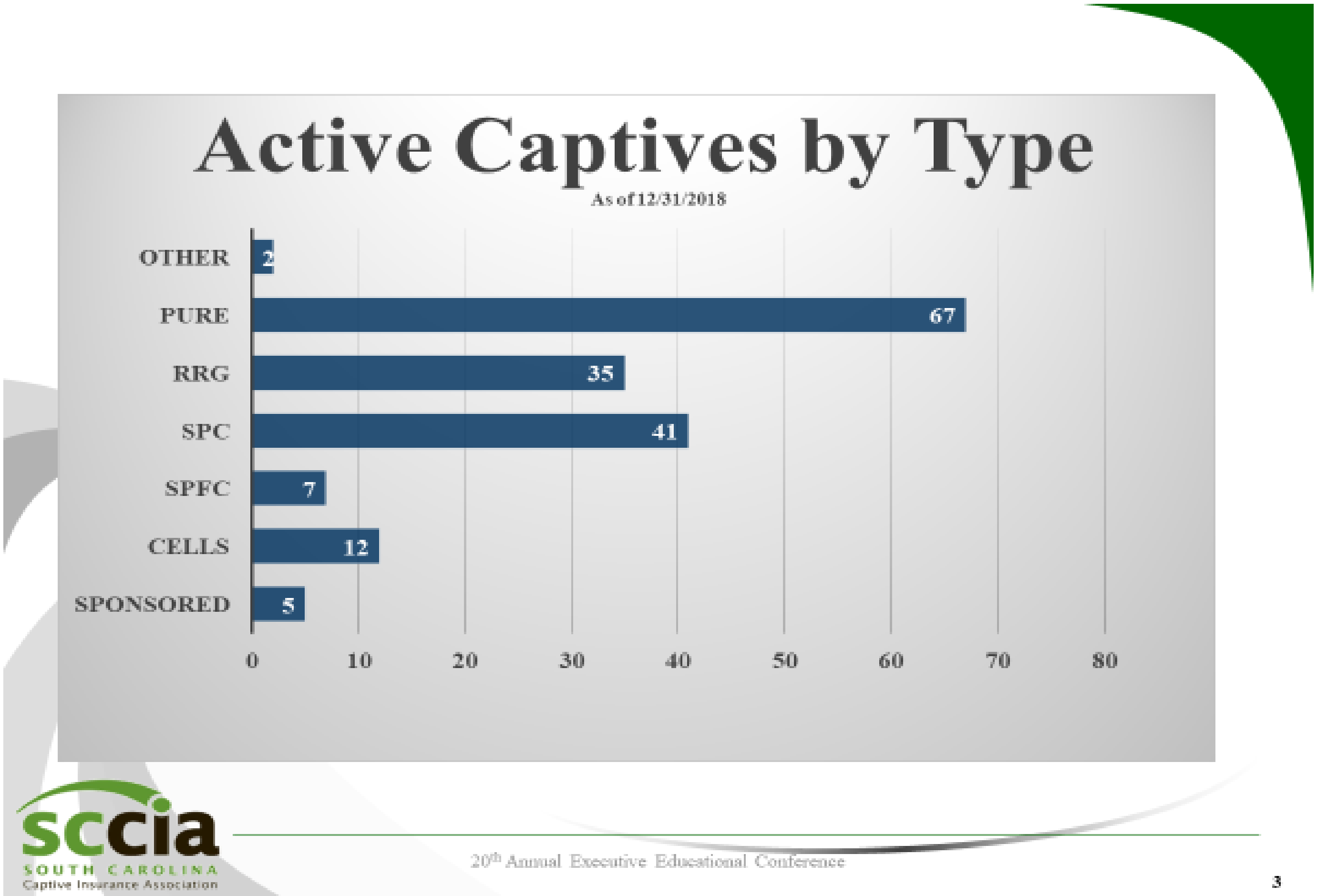
II. SC Captive Portfolio Overview

So, for this occasion, I'm pleased to share with you some data about the composition of our portfolio of active captives here in South Carolina – not so much because it is interesting *per se,* as because it constitutes persuasive evidence of the solid foundation for captive business that's been built up in our state over the 20-year history of our captive program.



This bar chart shows just how diversified our portfolio is by industry. Our captives come from many different industries, with no one or two industries predominating. You will observe that the three largest industry groups taken together account for exactly 2/3rds of our total. Those industry groups are *first*, Finance, Insurance, Real Estate, *second*, Health Care, and *third*, Transportation.

Implicit in this chart is the otherwise unstated fact that over the course of two full decades, we have acquired an in-depth exposure to the risk characteristics of a wide range of industries and business segments. This is not a state of affairs at which any of the more recently established (and appropriately modest) domiciles will arrive in a few short years, if ever.



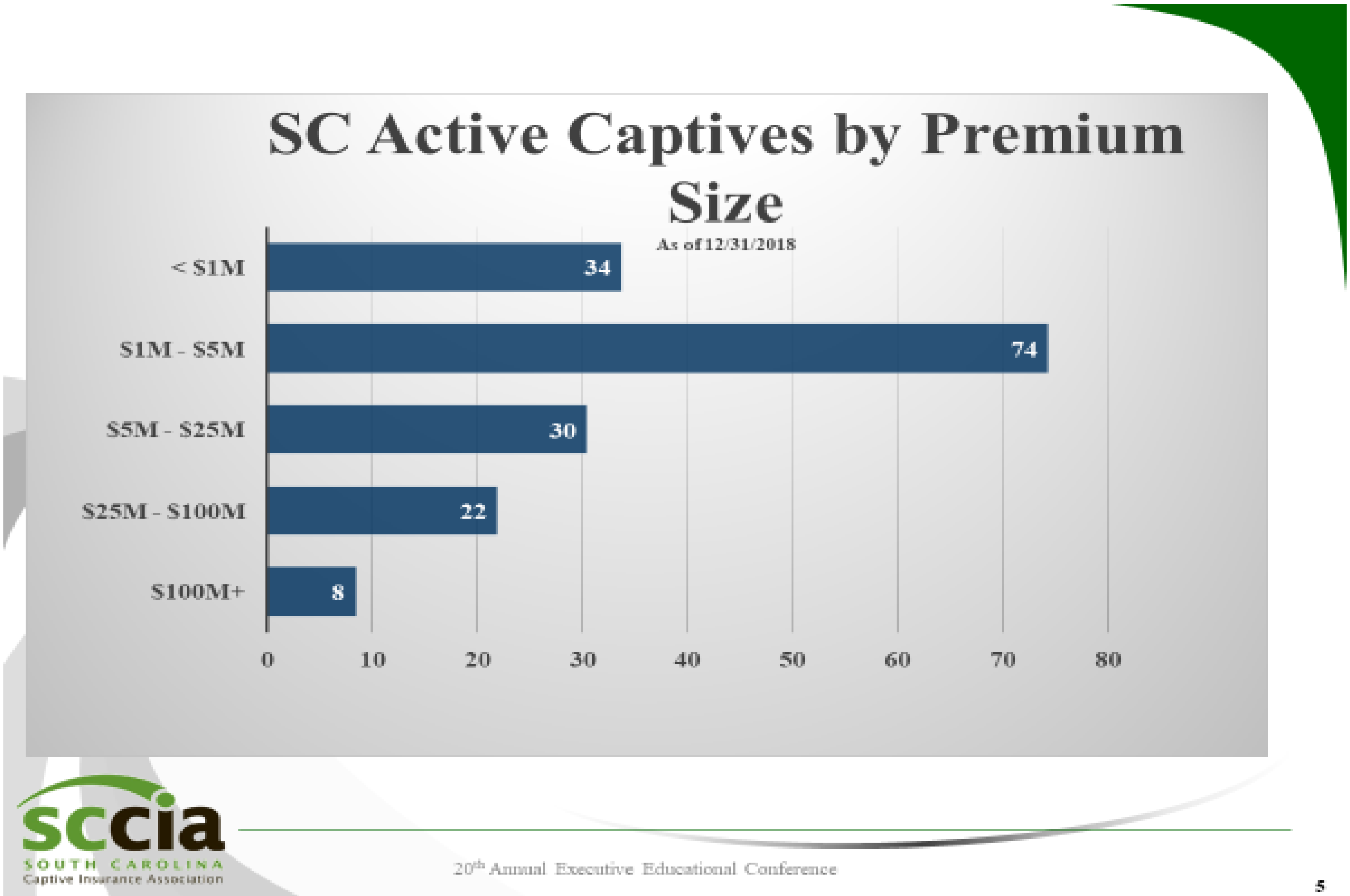
This slide shows the breakdown by statutorily defined categories of captives, the most salient points about which are the following:

1. 67 out of the 169 total active captives on our registry at year-end 2018 were pure captives.

2. We had 35 RRGs at the end of last year, which is the second highest number of any state domicile – second only to Vermont – and we expect to end 2019 with 39 or 40.

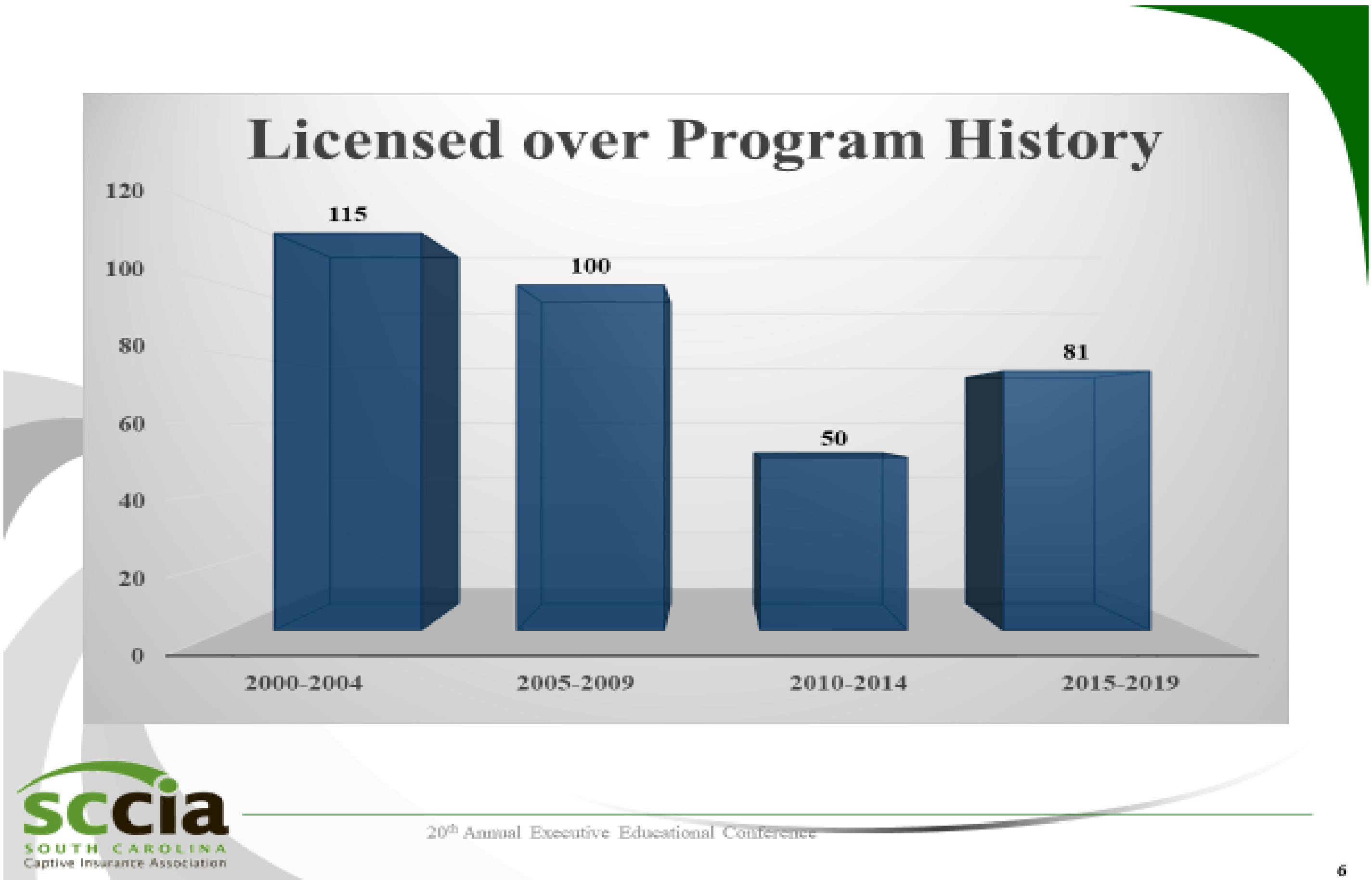
3. The 12 cell entities counted here are Incorporated Cells only ("ICs") only, and do not include a significant number of *unincorporated* cells, most if not all of which are extremely

large and robust in terms of their premium volumes and risk profiles, not to mention their highly sophisticated reinsurance arrangements.



From this slide, you will see that although the highest number of captives fall within the $1M-$5M band, we also have 30 active captives with over $25M in GWP and 8 with $100M or more in written premium.

One point I'd like to stress is that here in South Carolina we don't lose any sleep over Tax Court decisions favoring the IRS over 831(b) type captives and their owners. Although we do have some so-called microcaptives in our portfolio, and *we certainly do not discriminate against captive owners of moderate size* wishing to avail themselves of the 831(b) election, such captives by no means dominate our portfolio or define who we are as a domicile. In fact, it's worth emphasizing that in South Carolina we like to see captives formed first and foremost for risk management and risk financing reasons and not for tax reasons. At the point of licensing, we like to think that any company we license will still be operating *and operating soundly*, in 5-to-10 years, regardless of what decisions are handed down by the Tax Court in the intervening years.

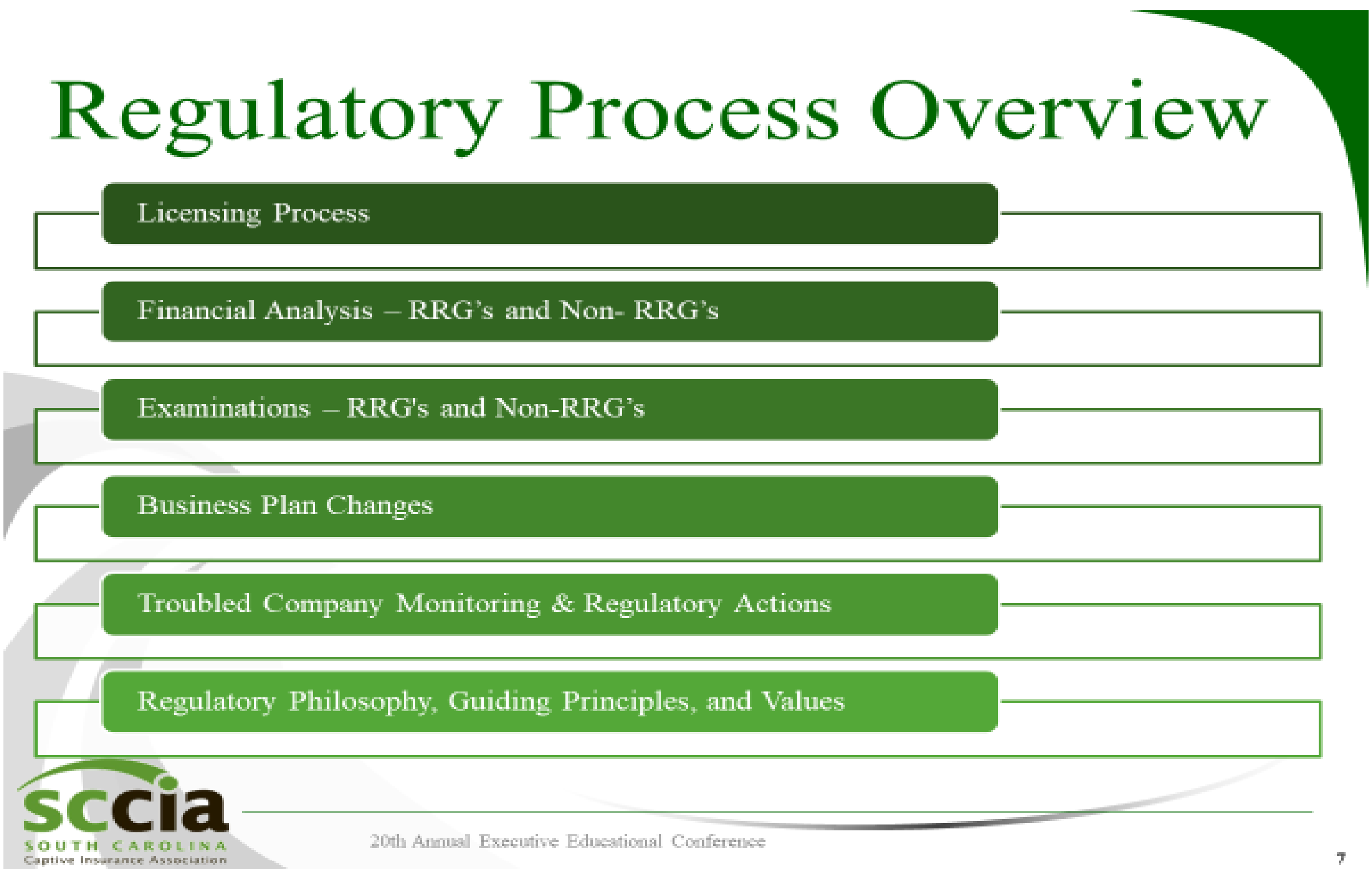


This picture breaks down our 20-year program into 5-year bands or blocks and shows the total number of captives licensed in each of those four 5-year blocks of time. You see immediately that the number of licenses issued during the 3rd block is only half the number for the 2nd block and less than half the number for the first 5-year interval. You might be tempted to ascribe that to the financial crisis that dominated the economic environment in that 2010-14 period. But other factors were also at work in producing these numbers. During the first 5 years of our program, according to every version of that period that has been related to me, the consistent message from the top our Department was, "Find a way to say 'YES'."

If that's your mandate, you're inevitably going to license some rubbish companies, and some of them will blow up. And that's exactly what happened, producing an overreaction by some in the Department during the next period of time, which was characterized by a restrictive regulatory approach toward captives. As we came to be regarded as less "captive-friendly" than some of our peers, the predictable consequence was that we licensed a lot fewer captives during that 3rd block of time, as you see on this chart.

I should add here, in the interest of completeness of context, that during the whole period of 2000 through 2012, the Department had a succession of several different Directors or agency heads, including one or two intervals with an Acting Director in charge, which meant that there was no continuity of commitment to the captive sector, and arguably very little understanding of the captive industry to begin with, and consequently no consistency and continuity of policy and practice regarding the licensing and regulation of captives.

The last point I'll make about this slide is that from 2015 to the present, our licensing totals have surged back up to healthy levels, now that Director Farmer has been the incumbent Director for over 6 years, and I have been Director of Captives for over 5 and a half years. Those two factors together have translated into a period of stability and



consistency that were not present or even possible under the shifting administrations of previous Directors of the Department.

This process overview chart simply lists the major functional or operational components of our Department's Captive Division – i.e., the basic, generic, recurring processes of licensing, financial analysis, examinations, business plan changes, and troubled company stewardship and related regulatory actions. With respect to financial analysis and examinations, the processes and approaches are different for RRGs than for non-RRG captives, largely due to nondiscretionary NAIC requirements tied to their Accreditation Program. And in case you don't know it, nothing gets the attention of state insurance commissioners and their deputies faster than mention of the word "*Accreditation*"!

Well, enough of the provincial perspective! Every year at this conference, the title of the session at which I am asked to speak is "Domicile Update" or "State of the Domicile" or something similar, and too many people seem excessively focused on licensing numbers, which as a subject is too narrow to provide much intellectual stimulation. What is *really* interesting, however – at least to me – is *risk and its relation to capital* – or to put it another way, the many and varied species of risk and the formation, type, and deployment of capital intended to attach itself to risk in order to generate returns to the providers of that capital. That, and *not* narrow lens issues like what individual states do or don't do, is what is truly interesting about this *economically indispensable risk* and insurance industry we're all a part of, and in particular this specialized and ever-evolving segment called captives, focused as it is on tailored solutions for risk owners.

So, in keeping with that thought, I am now going to pull the lens back from the provincial, domicile-specific perspective, and offer a more wide-angle perspective with some commentary about big picture shifts in the external environment which serves as the enveloping context for all our domicile-focused and domicile-specific initiatives, activities, and results.

In the next series of slides, I am going to shine a spotlight on 7 developments of high importance that you may have been too busy in your workaday lives to take cognizance of and assign relevance to. Think of these as a series of dots that I invite you to connect to each other and to the worlds of your own businesses and organizations as you see fit. In other words, I'm not going to connect them for you, but rather simply state them and hope you'll leave here thinking about at least some of them well after this conference has concluded, and can *glean something revelatory* in the relationships between them and the issues you and your organizations face every day.

III. Wide Angle Perspectives – The Bigger Picture

Taken together, I hope these points, which I'll call "***Buried Headlines***", will open your eyes to the *speed and ubiquity* of the changes all around us, to *how interconnected and mutually reinforcing* some of them are, and how wide and penetrating some of their impacts are likely to be, whether direct or indirect, on the future shape and direction of the risk industry as a whole, as well as on the sometimes all-too-insular worlds in which so many of us operate.

Buried Headline # 1: **Major shift from physical to intangible assets, but intangibles remain *substantially underinsured* relative to traditional physical assets.**

The nature of the assets that make up the preponderance of the value of the balance sheets of the S&P 500 companies has changed enormously over recent decades. In his first speech as Chairman of Lloyd's in June of 2017, **Bruce Carnegie-Brown** said, "The last two decades have seen a ***major shift from physical to intangible assets among major multinational firms.*** *Intellectual property, brand and reputation now account for 84 percent of the value of S&P 500 companies***"**, said Carnegie-Brown, noting that some major brands such as Skype own very little in the way of physical infrastructure or assets.[2]

John Neal, the CEO of Lloyd's, elaborated on this point in March of this year: **"***If you looked at a classic S&P company 40 years ago, 83% of their balance sheet would have been tangible assets. Today, it's only 12%.* The insurance industry is pretty good at insuring the tangible, but quite challenged at finding the appropriate covers for the intangible."[3]

As further evidence of the magnitude of changes taking place all around us, sometimes without our notice, here is **Buried Headline # 2: Composition of S&P 500 changed dramatically in the last decade.**

Energy Companies fall to only 4% of S&P 500 … ExxonMobil drops out of Top 10. A few points worth noting here:

a. "For the first time since 1925 [i.e., in 94 years] you won't find **ExxonMobil** – or its predecessor companies – among the top 10 companies in the S&P 500. The energy giant is now number 12 in company weightings. The top 10 consists of companies operating in tech, communications, health care, and financial services."[4]

b. "ExxonMobil is still a huge company, but a decade ago it went on a run of six straight years at number one. Today Microsoft, Apple and Amazon top the list."[5]

c. "Four decades ago, energy companies made up 25% of the S&P 500 index. Now it's 4%."[6]

<u>Buried Headline # 3</u>: Record Surge in Securities Litigation brings D&O market to a Crossroads.

"… **441 new securities class actions were filed in 2018, the most in any year since the aftermath of the 2000 dot-com crash. 2018 was also the fourth consecutive year of growth in the number of filings."[7] Watch for tightening of D&O market!**

A combination of a more litigious environment and years of falling premiums and expansions in coverage has brought the **D&O market** to a crossroads. "The D&O market has seen 14 years of generally soft conditions, providing buyers with favorable premium pricing and broad coverage enhancements. Over the last few quarters, however, we've seen a dramatic switch. Premium increases are now commonplace, and policy negotiations have become more difficult as insurers face pressure on primary, excess, and Side A – or personal asset protection – differences in condition pricing."

<u>Not-so-Buried Headline # 4</u>: (This was widely publicized and in some ways is the biggest of these "headlines")

American capitalism's sacred cow of shareholder value was recently relegated to only one of several distinct stakeholder values embraced by the Business Roundtable.

In a statement signed by nearly 200 chief executives, led by Jamie Dimon, and including the leaders of Apple, American Airlines, Accenture, AT&T, Bank of America, Boeing, and BlackRock, the BR has **redefined the purpose of a corporation** in such a way as to abandon shareholder primacy and embrace a much broader and more present-day ethic based on concurrent obligations to multiple stakeholders. In the words of one of the signatories, Johnson & Johnson Chairman Alex Gorsky, the statement is intended to reflect "the way corporations . . . should operate today". [8]

<u>Buried Headline # 5</u>:

"**Cyber is the one thing that scares me to death**. I cannot believe the amount of *silent* coverage that the industry affords. It's an accident waiting to happen."[9]

The speaker here is no less an industry titan than **Stephen Catlin**, who went on to say,

"If you think about wind, or a quake, or a man-made disaster, or even a political uprising, you're never talking about more than about 10 per cent of the world. With cyber, it's the **whole world in a nanosecond**. The ***aggregation* of exposure** is mind-boggling."[10]

<u>Buried Headline # 6</u>: Beware of Loss Creep! It may surprise you to learn, that:

"Despite a multitude of … catastrophes in 2018 [including unprecedented California wildfire costs and the strongest typhoon to hit Japan in 25 years], *the single biggest loss event for reinsurers* [in 2018] was so-called *loss creep* from *2017*'s Hurricane Irma."[11]

This is truly startling, coming after many years in which insurers and reinsurers had boosted earnings by harvesting favorable loss reserve development on prior accident years. The factors leading to loss creep – volatility, uncertainty, complexity, ambiguity, and interconnectivity – are causing a re-thinking of underwriting and risk model assumptions, risk appetites and capacity deployment, and the true nature of so-called "short-tail" lines.

<u>Buried Headline # 7</u>: War for talent intensifies. We're in a "candidate-driven market…"

I receive e-mail alerts from several executive search firms specializing in the risk and insurance industry, and more and more often I see them using the expression "war for talent", and sometimes "candidate-driven market" to describe the supply-demand dynamics of the market for talent in the industry.[12] I can scarcely go more than a day or two without seeing a headline or caption highlighting the challenge of enticing bright young talent into this industry to replace the record number of retirees leaving the industry every day – a phenomenon that will not abate any time soon.

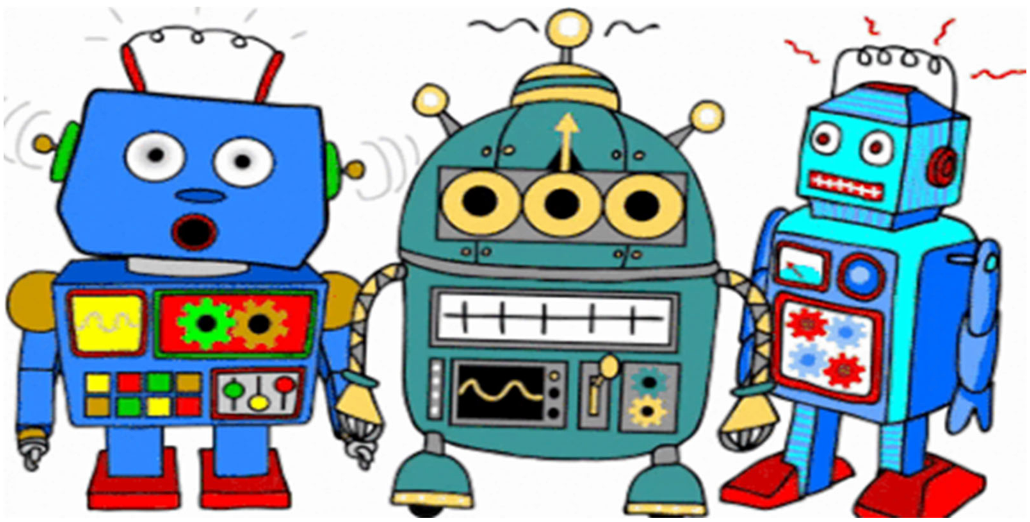
The national unemployment rate for August was 3.7%. For South Carolina it was 3.2%, and for Lexington County where I live it was 2.4%. [13] We're in a *virtually full employment* labor market, and our industry is competing with many others for the right mix of talent, character, and self-motivation to become the leaders our organizations will need to generate sustainable stakeholder value across multiple constituencies over the long term. At the same time, developments in machine learning and artificial intelligence are taking place that could have profound though still largely unknown effects upon labor market demand within just a few years. The interlocking worlds of risk management, insurance, and reinsurance, are more numbers-driven than ever before, and will be even more so in the future.

But having said that, I am confident that as an industry, we will soon be employing new and better tools to understand, model, structure, and price risk, thereby continuing to attract capital seeking acceptable risks to produce desired returns, and helping the wheels of business and industry keep turning. From time to time we need to remind ourselves that ours is *an indispensable industry, an enabling industry*, in the absence of which all other industries would suffer immeasurably, and some would not exist at all. I also choose to believe that captives will remain one of the more versatile and effective tools available for risk owners seeking to exert greater control over the structures, counterparties, and costs of their risk management programs.

These "headlines" are only a few of the many fascinating developments in the wider world of risk that I could have chosen to talk to you about – some of which would merit a full hour or more to unpack. I hope you have found them interesting, and that at least some of them will provoke further thought after you leave the conference.

As a closing thought, I must ask: Is it just me, or are any of you out there as weary as I am of being constantly reminded of how much our lives – both business and personal – are being disrupted? It seems that every time I turn around, I see another industry publication with the word "disruption" in a headline, and I find it very disconcerting.

I am not being nostalgic. After all, as **Michel Barnier** recently said, "Nostalgia serves no purpose." [14] Nevertheless, I must be in plentiful company in decrying the dizzying pace of change and the bombardment of unwelcome reminders about disruption. According to the **2019 Edelman Trust Barometer**, "there is a two-and-a-half-to-one margin of respondents who say the pace of innovation is too fast over those who say it is too slow."**[15]** But regardless of whether you fall into the "too slow" camp or the "too fast" camp, let's all ***try not to blame the robots!***[16]



Thank you for your attention, and have a great conference!

FOOTNOTES:

1. Dominique Enright: *The Wicked Wit of Winston Churchill* (Michael O'Mara Books Limited, 2010), p. 68. Churchill also called Atlee "*a sheep in sheep's clothing".* Ibid, p. 68.

2. https://www.gccapitalideas.com/2017/10/10/industry-must-act-to-avoid-a-kodak-moment/.

3. Quoted in "*2019 Intangible Assets Financial Statement Impact Comparison Report",* p.1, published by Aon and Ponemon Institute. See also: https://www.aon.com/thought-leadership/ponemoninstitutereport.jsp.

4. *Marketplace*, NPR, September 3, 2019. https://www.marketplace.org/2019/09/03/exxonmobil-out-of-sp-500-top-ten/

5. Ibid.

6. Ibid.

7. "*Directors & Officers Liability: Three Emerging Areas to Watch*", by **Sarah Downey**, D&O Product Leader at Marsh, published in Marsh's BRINK publication, August 21, 2019, https://www.brinknews.com/do-liability-three-emerging-areas-to-watch/.

"And smaller to midsize companies that once barely caught the eye of the plaintiffs' bar are now squarely in their crosshairs."

"What's more, following the March 2018 U.S. Supreme Court decision in ***Cyan, Inc.*** ..., companies going through initial or secondary public offerings are now more likely to be met with litigation in both state and federal court than before."

8. https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans

No doubt the celebrated British economist **John Kay** has already applauded this move, though he may well have wondered what took the Americans so long. In his splendid little 2010 book titled ***Obliquity***, Kay, a fellow of St John's College, Oxford, a professor at the **LSE**, and a regular columnist for the **FT**, quoted **Jack Welsh** approvingly as having said, **"Shareholder value is the dumbest idea in the world."** Welsh went on to point out "that the injunction 'maximise [*sic*] shareholder value' is **not a useful guide to executive action**. 'That's not a strategy that helps you know what to do when you come to work every day.'" John Kay: Obliquity (Profile Books, Ltd., 2010), p. 27, 42.

Kay even queries the absolute nature of profit itself, by stating, **"Profit is a fact. Or is it?"** He then points out that, "**Shareholder value and return on investment are not the same thing, and neither is the same as profit**, as defined by IFRS or GAAP or any other standard." Ibid., p.73. He seals his argument with the observation that "no one will be buried with the epitaph 'He maximized shareholder value.'" Ibid., p. 79.

9. "Silent cyber", sometimes called "non-affirmative cyber", is the term increasingly used to denote losses that may trigger traditional property and casualty policies not intended to cover cyber exposures.
https://www.gccapitalideas.com/2019/07/15/review-of-silent-cyber-coverage-on-gc-capital-

ideas/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+gccapitalideas+%28GCCapitalIdeas.com%29.

According to Guy Carpenter, the "systemic nature of cyber risk means *silent cyber is becoming endemic in virtually every type of insurance policy*." (emphasis added) https://www.gccapitalideas.com/2018/11/20/affirmative-versus-silent-cyber-an-overview/ .

10. One of the (re)insurance market's leading figures, Stephen Catlin established an underwriting agency at Lloyd's in 1984 with two people and £25,000, built the largest syndicate at Lloyd's, and sold his group to XL for $4.2 billion in 2015, by which time it had grown to 55 offices in 21 countries and 6 underwriting hubs.

11. Quote from **Dirk Lohmann,** Head of ILS at Schroders, published in 28-02-2019 article titled "*What ILS funds must learn from Irma*", in *Intelligent Insurer*. See https://www.intelligentinsurer.com/contributed-article/what-ils-funds-must-learn-from-irma.

For more examples of loss creep and its implications for (re)insurers and the *notion of insurability itself*, see: https://www.gccapitalideas.com/2019/09/25/the-changing-nature-of-riskparti/?utm_source=feedburner&utm_medium=feed&utm_campaign=Feed%3A+gccapitalideas+%28GCCapitalIdeas.com%29 **.**

12. Here are just a few examples:
https://www.fastcompany.com/34512/war-talent

https://www.agcs.allianz.com/news-and-insights/expert-risk-articles/millennials-and-the-coming-war-for-talent.html

https://www.carriermanagement.com/features/2019/08/12/196339.html

13. https://columbiabusinessreport.com/news/human-resources/77128/ For September, the national rate was 3.5%, and the rate for South Carolina had fallen to 2.9%. https://columbiabusinessreport.com/news/human-resources/77315/

14. https://www.nybooks.com/daily/2019/05/29/nostalgia-serves-no-purpose-an-interview-with-michel-barnier/**.** Michel Barnier is the EU's chief negotiator with the UK on Brexit, and is a former European Commissioner for Internal Market and Services.

15. https://www.edelman.com/trust-barometer

16. https://www.epi.org/publication/technology-inequality-dont-blame-the-robots/

See also: https://www.foreignaffairs.com/articles/united-states/2017-08-30/dont-blame-robots.