Emerging Risks Driving Growth For Smaller Captives

By: Karrie Hyatt

One of the hottest topics at captive conferences and meetings lately is what new risks are developing that could be covered by the alternative risk transfer market. Supply chain and cyber liability are probably the most talked about in recent years, but how are they playing out in the captive space? While the traditional market will certainly cover these emerging risks, it is in the smaller captive space where they will likely find a good fit.

The Top New Risks for Captives

The three risks that many industry insiders believe are the hottest right now are supply chain, cyber and reputational. Supply chain liability became high profile after the 2011 earthquake and tsunami in Japan, followed by the severe flooding that same year in Thailand. The areas affected by the natural disasters were key manufacturing regions and businesses all over the globe felt the economic pangs when their businesses were disrupted by natural disasters in these far flung places. Looking to avoid large losses for disrupted supply chain, more and more companies are seeking insurance coverage in this area.

Cyber risk has been at the forefront of emerging risks for the last several years. However, it was mostly talked about but hardly ever underwritten. Businesses knew that it could be huge risk, but weren't eager to get expensive coverage for it. Even as experts warned that the likelihood of a cyber data breach for any company was "a when, not an if." The data hack of Target in December 2013, when the data of millions of the company's customers was stolen, was an eye opener to industries and companies of all sizes. Cyber liability insurance will likely be one of the most sought after insurance products for the next few years.

Hard on the heels of cyber risk is reputation risk. Reputation risk, unlike other emerging liabilities, is based on other risks—cyber, of course, product recall, errors and omissions, third party and similar types of risks will all affect a company's reputation if an occurrence should happen. A breach in the data systems of any company or a defective product is going to affect its reputation. Also affecting reputation, especially in recent years, is the explosion of social media where one bad review can go viral and reach far more people than it ever could before.

TRIA, Catastrophic and Other Emerging Risks

TRIA, the Terrorism Risk Insurance Act, is due to expire this year, but will most likely be renewed. According to Ellen Charnley, managing director, Marsh Captive Solutions, "The TRIA act is expiring at the end of the year and is likely to be renewed. There has been a significant amount of talk about the form it will be renewed in. I think the general consensus is that it will be renewed in which case TRIA coverage for captives will continue to be a hot topic and a good opportunity." The U.S. Senate introduced a reauthorization bill for the Act in mid-April. The introduction to the bill was welcomed by the insurance industry, except for a controversial provision that would increase deductibles

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to 20%. The bill had not yet passed the Senate at the time of publication and a corresponding bill has yet to be introduced into the House of Representatives.

The last five years have seen some the worst natural disasters on record. So it makes sense that interest in catastrophic risk—earthquake, flood, wind and weather risks—has increased exponentially. Catastrophic risk goes hand-in-hand with supply chain and reputational risks as well. Jon Harkavy, executive vice president and general counsel with Risk Services LLC, thinks that due to the recent natural disasters, property coverage in captives will begin to take more precedence. "Property has not usually been the focal point of captive coverage but with the extreme weather and rising costs, there may be additional focus on property captives…. Much depends on whether the federal government and/or states (like Florida) will continue to subsidize the price of property coverage in flood and related loss prone areas, in which case the captive mechanism might not be economically feasible."

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Other emerging risks that are gaining traction are credit default liability, product recall liability, third-party liability and employee benefits liability. Third-party liability may the fastest growing of these. "I think what we'll see is more third-party related risks in captives, some of it relating to employee risks, but it will be the voluntary benefits that employees can opt-in for. Things that aren't mandated by ERISA, and therefore aren't under the same scrutiny of the Department of Labor," said Charnley, "Other areas of third-party risks that we see gaining significant traction in the captive space would be in relation to customer risks (for example, extended warranty type risks). These risks are often sources of underwriting revenue for captives since loss-ratios tend to be favorable."

Why Place These Risks in Captives?

Many of these emerging risks tend to have a low rate of incidence but are big in losses which makes placing the risk in captives a viable solution. Because they are new, without the underwriting history of more conventional risks, they are much harder to underwrite than something like general liability or workers' comp, so purchasing coverage in the traditional insurance market can be quite costly for emerging risks.

However, Charnley thinks that these types of risks lend themselves to being covered by captive companies. "I would say that the majority of the growth that is out there right now is in the small captive space. We are seeing a tremendous amount of growth in small captives and there are a whole host of risks that people are starting to write that are high severity, low frequency in nature. Risks such as EPLI, credit default, product recall, errors and omissions, cyber, even political risk in some cases, catastrophic risk such as quake, flood, wind and weather, and reputational risk. There are many risks that an organization could be exposed to but typically wouldn't want to go out and buy traditional coverage for because it would be cost prohibitive to do so."

To find out how the developing risks play out in the market, we will have to wait and see. Whether cyber, reputation or supply chain coverages find a home in the traditional market or if the captive space will better suit the risk, time will tell. However, captives will likely have a big role to play. As Charnley concluded, "I think what's cool about captives is they are a tool, and you can do pretty much what you want with a captive."

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