Brighton NEWSLETTER

You insure, We ensure

Editor's Note

"It takes 20 years to build a reputation and five minutes to ruin it." – Warren Buffet.

Recognising the truth in the above statement, companies have ranked reputation risk at the top of their business agenda. But quantification of such risk remains the biggest challenge because reputation is not easy to understand, measure, insure and mitigate.

To this effect, captives can play a vital role in self-insuring reputational risk. As highlighted in our first article of this issue, the hardening market has generated greater interest in captives for tailored coverage, including reputation risk.

Interest in captives has also expanded to include cell captives, which have been dubbed as one of the most important steps in the evolution of captive insurance. With its lower barriers to entry, cell captives provide an attractive option for a wider pool of companies.

In this issue, we also covered the recent webinar, jointly hosted by Park Lane PCC Limited and Labuan IBFC Inc, where panel of experts shared their insights on how cell captives may be the solution towards developing a customised risk management programme.

Until the next issue, stay safe and well.

Annie Undikai,
Managing Director

Captives For Reputational Risks

Over the past decade, reputational risk has risen to the top of the list of important business issues. But it has never been more important to a business' future health following the COVID-19 pandemic. In the recent Global Reputational Risk Management Survey Report published by Willis Towers Watson, it was revealed that 86% of respondents were concerned about loss of income and a reduced customer base due to reputational risk.[1]

The pandemic has amplified a host of reputational risks and challenges to businesses. We have seen how operational risks arising from the pandemic, including disruptions to business continuity, global supply chain interruptions and cyber risks, have eventually evolved into reputation risk.

[1] https://www.willistowerswatson.com/en-MY/Insights/2021/01/global-reputational-risk-management-survey

In a digital age where the world of reputation risk has enlarged, the scale of the challenge has become more apparent during the pandemic as more and more people are now interacting with companies online. On top of this, the internet and social media have provided consumers with a greater platform to amplify their opinions than ever before.

Social media has become a very powerful and vital tool for companies to promote themselves, but it's also a platform that can damage a company's reputation fast. A case in point was the campaign to boycott Boohoo, an online fashion retailer, when the company was discovered to have paid employees far below the legal minimum wage. A #boycottboohoo campaign was soon trending on social media platforms. As a result, Boohoo shares dropped by 18%, and more than £500 million was wiped off the value of the fast-fashion website.

The pandemic has also enhanced society's and businesses' reliance on digital technologies as remote learning, virtual classroom and work from home were universally adopted overnight. As a result, cyber exposures have escalated to unprecedented levels and brought associated risks such as reputational damage, loss of data and intellectual property security, into sharp focus.

As increasing number of companies are beginning to see the importance of risk transfer for reputational risk; captives are prominently being recognised as key to reputational risk financing. The role of captive in reputation risk management is even more vital now as companies start to embrace the conceptual value of environmental stewardship, social justice, and responsible governance (ESG).

Over the years, benefits of captives have strengthened as advancement in technology in the areas of data management, data analytics, and risk-quantification techniques; have enabled captives to produce more precise actuarial models and underwrite emerging risks more effectively.

Captive also has a strategic role in insuring against reputation risk. A captive provides a valuable shorthand story as it relays to key stakeholders that a company understands the meaning of reputation value and risk.[2]

From a tactical perspective, captive provides accessible cash that equity investors can appreciate and value in the equity markets before, during and after the company experiences a reputational crisis.

But what makes captives appealing is their ability to tailor coverage for complex or unique exposure where insurance is either unavailable in the commercial market or may be too expensive, including reputational risk. With the hardening market and the costs of traditional insurance increasing, businesses are now turning towards captives for tailored coverage more than before.

[2] https://www.captiveinsurancetimes.com/specialistfeatures/specialistfeature.php?specialist_id=315&navigationaction=features&page=2&newssection=features

Growing Interest In Cell Captives As Risk Management Solution

Interest in captives continues to gain momentum amidst the continued hard market and cyclical COVID-19 surges. There is also a growing appetitie for captives within the Middle East and Asia Pacific. While only 3.5% of captives worldwide are domiciled in Asia-Pacific, Middle East and Africa; captives formation in these region has been growing in the past few years. It was reported that in the Asia-Pacific region captive formations grew by 6.3% in 2020, whilst the MENA region registered a growth of 3.4%.[1]

Within the global captive industry, there is a growing trend in the use of cells as part of risk management solutions. As highlighted by the World Domicile Update 2020, about 336 new cells were formed in 2020, bringing the total number of cell captives to 3,039. Cell captives have traditionally been utilised by small to midsize companies as the structure offers cell owners the same risk management and risk transfer facilities at far less costs than a standalone entity. But it is now increasingly common for large multinationals to create their own cell captives through which these vehicles are used to write their own insurance risks.

[1] World Domicile Update 2020

The surge of interest in cell captives has been mainly attributed to the hardening market, which continued to gain momentum amid the COVID-19 pandemic. In a recent report published by the Centre for Financial Regulation and Inclusion (Cenfri), it was highlighted that cell captives have been one of the most important steps in the evolution of the captive insurance space and have become an integral component of the self insurance market in many of the established captive domiciles.[2]

What makes cell captives appealing is the segregation of the assets and liabilities of each individual cell of a company, which is likened to that of a honeycomb structure. This ring fencing feature ensures that a claim against one cell cannot be impacted or covered by the assets of another cell. This is in addition to the ease of implementation and lower operating costs as compared to a standalone or pure captive.

As a valuable risk management tool, cell captives provide owners greater degree of control over how their insurance programme is managed and enable owners to customise their risk financing programme to meet their needs and requirements. Cell captives may be formed for several business purposes as they have the ability to separate risks by lines of business, geographic region and risk/responsibility centres. For instance, a company with many business interests and subsidiaries may adopt cell captives for its insurance risk solutions in order to ring fence each subsidiaries' insurance risks instead of co-mingling in a pure captive.

Similarly, a company that has businesses in different geographical locations can address different business risks that are unique to each locations or to address the different legislations imposed by different jurisdictions where the company's businesses are operating in.

But the traditional structure is the establishment of a PCC special purpose vehicle by an insurance company with a view to rent cell captives to its clientele. Under this cell structure, companies can choose to self-insure risks by owning a cell in the special purpose vehicle insurance company. This would allow them to tailor the coverage to their specific risks and needs. Whether its segregated cell companies, protected cell companies or rent-a-cell captives; the concept and use of cell captives has become increasingly widespread as a growing number of companies are choosing cell captive as a valuable risk management tool.

[2] https://cenfri.org/wp-content/uploads/FSDA-and-Cenfri_The-potential-of-the-cell-captives-structure-for-sub-Saharan-Africa.pdf

Turnkey Self-Insurance Solutions via Cell Captives

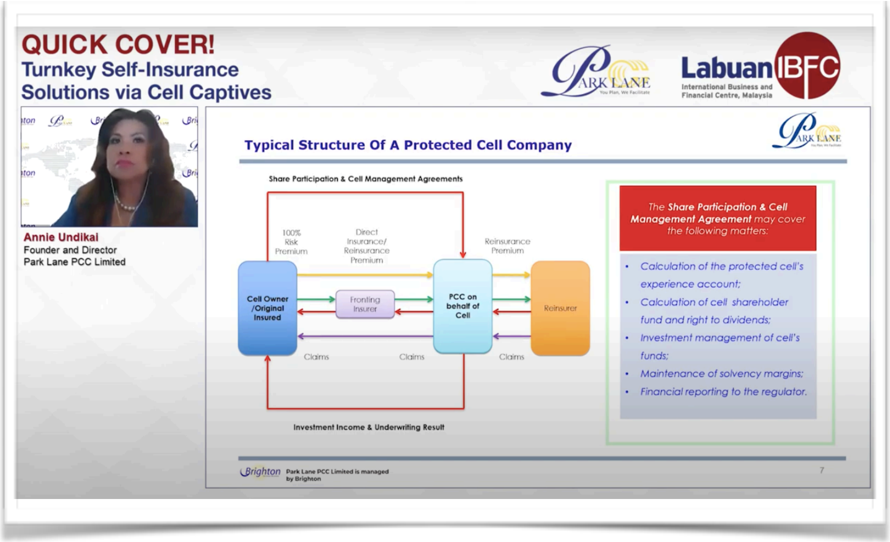
Cell captives have become extremely popular self-insurance tools for companies of various sizes across all sectors and continues to gain momentum in response to challenging economic conditions and the rising cost of insurance. In a recent webinar titled "Turnkey Self-Insurance Solutions via Cell Captives," jointly hosted by Park Lane PCC Limited together with Labuan IBFC Inc, panel experts shared their insights into the Asian risk landscape (present and post COVID-19), and how cell captives may indeed be the solution towards developing a customised risk management programme. Moderated by Farah Jaafar-Crossby (CEO, Labuan IBFC Inc.); panel experts included Woon Khai Jhek (Senior Economist, RAM Rating Services Berhad), Annie Undikai (Founder & Director, Park Lane PCC Limited), Abdul Halim Jantan (CEO, Sterling Insurance Brokers), Oliver Schofield (Head of Captive & Alternative Risk Transfer (ART) Consulting, Principal Re) and Firas El-Azem (Managing Partner, FEA Versicherungsmakler GmbH).

The webinar kicked off with an overview of the Asian and MENA risk landscape and outlook, at present and post COVID-19, by Woon Khai Jhek, Senior Economist at RAM Rating Services Berhad. In his presentation, he explained that the global economic rebound is fairly certain. The World Bank predicts a strong but uneven recovery in 2021 with global economy is set to expand to 5.6%. The IMF also raised their forecast to 6%, indicating a relatively healthy economic prospects moving ahead. However, he cautioned that 2021 will remain a challenging year with many uncertainties as well as risks.

Looking at the growth prospects of economies in the Asia and MENA region, Woon Khai Jhek said that most countries are expected to rebound but with an uneven recovery. In Asia, India and China are expected to lead the recovery, whilst other countries are expected to experience growth below the forecasted global growth rate for 2021. For the MENA region, the economies of Israel and Morocco are forecasted to lead the recovery in the region.

He went on to the share 4 notable key downside risks to growth; which are recovery post-COVID-19, financial markets volatility, socio-economic risks and geopolitical risks. He further added that the road to post-pandemic recovery will hinge on several factors including COVID-19 containment measures, access to and distribution of vaccines, scope of policies to support growth, and measures to mitigate economic scarring from the pandemic. However, he stressed that the pandemic will likely widen income gap, notably in the developing countries.

Annie Undikai, Founder and Director of Park Lane PCC Limited, shared her in-depth experience and insights into the development of captives and how they can be used effectively as a risk financing tool. She elaborated that as a form of self-insurance, captive represents a viable alternative to traditional insurance coverages. The popularity of captives as an alternative risk transfer is based on their flexibility, diversity and the economics these vehicles offer.



In her presentation, she highlighted key factors that have contributed to heightened interest in captives in recent years. She explained that the hard market, which is characterised by sustained and significant rate increases, reduced capacity, coverage restrictions, and increased reinsurance costs; had prompted companies to explore self-insurance such as setting up a captive insurance company.

Annie Undikai highlighted that Labuan IBFC has become the jurisdiction of choice for the formation of captives in the Asian region. As at mid-2020, the Labuan captive business continued its growth momentum with premiums increasing by 14.2% to US$457.5 million, where 64.5% of its total premiums originated from international markets including Europe. At the end of 2020, 10 new captives were recorded in the jurisdiction; comprising of 3 pure captives, 2 master-rent-a-captive and 5 protected cell captives. This represented a growth of more than 300% in terms of numbers compared to 2019. This growth momentum continued in 2021. By mid of this year, the jurisdiction recorded an additional 5 new subsidiary-rent-a-captives.

The Labuan Financial Services & Securities Act 2010 (LFSSA) provides for the establishment of the following captive structures: pure/single captive, group/association captive, rent-a-captive, protected cell captive/master rent-a-captive, and multi-owner captive. She stressed that Labuan IBFC is the only jurisdiction in Asia to offer protected cell companies (PCCs), both conventional and Shariah-compliant.

According to Annie Undikai, a PCC is structured in such a way that each cell is created around a central core of the company, with each cells insuring or reinsuring the risk of the different cell owner. Hence, each cells are legally and functionally separated, distinct and independent from each other. The segregation of assets and liabilities of each individual cells is what makes cell captives attractive to business owners. This is in contrast to the traditional pure captive where all the cells combine to create one legal entity and each cell is not treated as a separate entity.

She explained that for companies wishing to set up cell captives in Labuan IBFC, they may engage the service of Park Lane PCC Limited; which is licensed as a protected cell company, captive insurer, with a takaful window. Each cell under Park Lane PCC can conduct general insurance, life insurance, takaful and family takaful. However, Annie Undikai cautioned that a cell cannot transact all 4 business at any one time. If the cell owner wishes to transact more than one business, then more cells are required, i.e. one cell for each business segment.

In presenting the benefits of setting up a cell in Park Lane PCC, she stressed that the creation of a cell is relatively easy and fast as it does not require the approval of Labuan FSA, only a mere notification within 14 days of the cell creation would be sufficient. Notifications may include material information such as cell ownership, cell name, cell share capital, cell insurance/reinsurance programme and the cell management agreement with Park Lane PCC.

Additional benefit of establishing a cell captive is the lower set up cost as compared to a pure single-parent captive. As explained by Annue Undikai, a cell in Park Lane PCC is not required to meet with the substance requirement as this would already be complied by Park Lane PCC. Furthermore, a cell is also not required to have a specified minimum capital outlay. The cell will also not incur any costs related to BOD meetings or travelling expenses as well as compliance function costs.

During the panel discussion, panellists shared their insights into self-insurance via the formation of cell captives and answered various questions posed by participants. In addressing to the reason why there is a reinsurer when a PCC is already a self-insurance solution, Oliver Schofield said that the reinsurance provides a catastrophic protection to the captive in the event that there is some unprecedented and unexpected deterioration in the severity and frequency of losses to that captive vehicle. In this case, the reinsurance allows it to cap its overall exposure in any one particular financial period.

In explaining the ways claims are handled within a cell or in a pure captive, he said that this is no different to those handled by brokers and the traditional insurance/reinsurance market place. There will be a policy of insurance issued from the cell/pure captive to its parents, which will contain conditions and coverages for claims settlement. In such case, a captive manager will employ underwriters to determine the viability of the claim and process it as it would any other claims from the insurance market. Oliver Schofiled added that it is crucial for captive to recognise that it must only pay valid claims and not just passing money to its parent for claims that are not covered by the policy. This is because any income received back by the parent company is likely, under standard accounting regulation, to be considered as taxable income. Whereas if it's a claim, it is deemed as a non-taxable income.

In terms of converting a cell into a pure captive, Annie Undikai explained that cells are easily converted into standalone captives as it only requires submitting an application to Labuan FSA. After which the cell owner would need to incorporate the company and transfer the entire assets and liabilities of the cell to the newly formed captive. Abdul Halim Jantan added that ideally companies would want to start with a PCC, but ultimately they should strive to convert it to a standalone captive insurance company overtime. He further advised that companies should start with a cell captive with a view to learn the business, but should convert to a pure captive as soon as they can accumulate enough capital. In other words, cells can be used as an incubator for specific short term projects or as a way for the company to get its feet wet before forming a wholly owned captive.

Firas El-Azem shared his views on the growth of self-insurance in the MENA region, which according to him has been lagging behind. He said that the captive business in the region is still very small with only about 12 captive businesses being established in the whole of GCC. But there is growing interest in captives due to the hardening of the market and the introduction of risk-based capital requirements in the MENA region. He further added that recent regulatory developments have also made it easier to form captives in the region.

He cited Abu Dhabi, Qatar and Bahrain as jurisdictions in the GCC that have created dedicated captive-specific legislations, which are largely modelled on historically successful captive jurisdictions such as Bermuda and Guernsey. Meanwhile, the Dubai Financial Services Authority recently enacted new regulations that allows for captive insurance and special purpose vehicles to be established through a protective cell company structure.

Firas El-Azem added that although Saudi Arabia, Oman and Kuwait still do not offer dedicated captive regimes, a number of large companies from these countries, including Saudi Aramco, Kuwait Petroleum and SABIC, have their own captives but outside of the GCC. He also highlighted that interest in captives is no longer confined to the traditional users of captives in the energy and heavy industry sectors, and state oil enterprises. A range of different businesses are now looking at self-insurance options as they become increasingly sophisticated in their understanding of risk management.