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RISK PARTNERS

Captives and the commercial property market

The hardening market has encouraged commercial property companies to reconsider their insurance arrangements. Captives offer numerous advantages that can translate to better or cheaper coverage, says Gary Osborne of Risk Partners.

After a lengthy period during which no major hurricane made landfall in the US, the years 2017 and 2018 had five major storms: Harvey, Irma, Maria, Florence and Michael. In 2019 the US again escaped relatively lightly, with only Hurricane Dorian impacting the mainland. However, these named storms, along with active tornados, major flooding and increased hailstorm activity, have resulted in substantial underwriting losses for the commercial property markets.

In 2019, and already in 2020, this has resulted in a return to "hard" market conditions. Policyholders are being subjected to premium increases of between 10 percent and 50 percent. In some cases, they are being forced to retain higher retentions or aggregates. This has led many commercial property companies, especially in the apartment management sector, to look at the use of a captive to address expensive or unavailable capacity offerings in the commercial insurance marketplace.

What drives consideration of a captive for these property risks?

- Lender or contractual requirements for low retention;
- Difficulty in collecting deductibles from different investor pools;
- Pricing mismatch based on broad-brush underwriting;
- Substantial deductibles for wind and earthquake zones; and
- Expansion of 831(b) premium limits gives potential to build catastrophe reserves efficiently. >>>

Lender or contractual requirements for low retention

The government and financial lending institutions both have contractual requirements for borrowers to maintain commercial property coverage on buildings they have financed. The insurance requirements often mandate coverage is to be purchased with a $25,000 or $100,000 deductible.

As companies build substantial property portfolios, these deductibles make no sense for entities that have upwards of a billion dollars under management and annual loss estimates reaching into the millions. Markets will not offer coverage down to that level, or will only do so with a large aggregate retention to be reached before that level of coverage is triggered.

An example would be a commercial property policy that is issued with a $100,000 per occurrence deductible, subject to a $1.5 million aggregate, capped at $500,000 per occurrence. In this example, there is no insurance coverage for three $600,000 property claims: the fourth would still have a $100,000 deductible.

This may be the most cost-effective coverage available, but how do you meet the lender's contractual requirement? The issuing carrier will accept that there is coverage down to $100,000 per occurrence when the aggregate is either funded directly to them or funded through a captive insurance vehicle.

The captive may be funded with $1.2 million in premium and $300,000 in capital (the split should be actuarially determined to pass the requirements for risk to be transferred). This is not necessarily tax-driven, but helps ensure the equitable treatment of investors, and the possibility of loss is handled across the various managed properties. It can cause major issues for investors if the higher retentions are put in place for cost efficiency but a loss to one property then results in that investor pool having to take the hit for a major loss event.

Difficulty in collecting deductibles from different investor pools

Many residential management companies own a small percentage (if any) of each property they manage. They will have a pool of investors they rely on to finance a new equity fund or specific project. They will have a controlling management contract that will assign them responsibility for the administration of the properties and that will also include the procurement of appropriate insurance coverage.

If the coverage has effectively a $500,000 per occurrence deductible for the first three major clams, but would then drop back down to $100,000 for a fourth major claim, how would you deal with collecting the deductibles from the differently affected properties and the different investor pools?

"Collecting the funding for the expected losses under these aggregate-plus policies in a captive spreads the risk among all the projects more equitably."

Would you, as an investor, be happy if your project financials took a $500,000 loss but you knew that another project took only a $100,000 loss because an aggregate policy feature was used up?

Collecting the funding for the expected losses under these aggregate-plus policies in a captive spreads the risk among all the projects more equitably. The premium charged will probably reflect actuarial indications based on locations and exposure to loss factors, such as wind, hail and earthquake.

One question to be addressed is what should happen to any underwriting profit captured by the captive. Does this belong to the management company? Or should it be allowed to accumulate to protect properties against adverse years or further market hardening, causing changes to retentions, etc, in future years?

Pricing mismatch based on broad-brush underwriting

Captives are increasingly used for buildings that are in flood or wind-exposed locations, where commercial underwriters do not recognise that structural factors should mitigate losses from wind and water. For

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example, a residential eight-storey tower block in Florida was effectively a concrete block: the first two floors were used for parking. The probability of flood damage remained but was limited given there were no inhabited apartments within six metres (20 feet) of the ground. The wind and fire risks were also lower because the building was outfitted with a sprinkler system and was concrete.

The owner took a much higher retention on this property as the pricing from the commercial marketplace was heavily driven by its location. The owner felt insufficient underwriting credit was being given to the mitigating factors. The premium difference was written into the captive to accumulate for possible losses.

Substantial deductibles for wind and earthquake zones

The concept discussed previously also applies where commercial policies will impose large deductibles for wind and or earthquake zones. If a commercial property manager has $1 billion of California property they could be facing a 15 percent earthquake deductible. The math tells you that could be a $150 million problem, and there are few affordable solutions to address this problem. Insurance products are expensive because there is almost zero doubt that there will be major earthquakes in California: it is mainly a matter of where and when they will occur.

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A captive can help in this situation, with premiums being collected to accumulate funds that can cover a catastrophic event that will happen at some point. The reality is that while the exposure is $150 million, it is likely that a more realistic maximum probable loss can be determined that may be closer to the $15 to $25 million range, depending on the spread of managed properties across the earthquake prone states.

The attractiveness of using a captive to address these property issues changed dramatically in 2017.

Expansion of 831(b) premium limits gives potential to build catastrophe reserves

Property is a short tail coverage: you know the profitability of an underwriting year very quickly, as there is rarely a deterioration of significance from property events. Thus, for many years, property was not seen as a candidate for a captive. If you had made an underwriting profit at the end of the year it was likely to be taxed and there was no ability to post reserves and defer recognising income until loss outcome was more certain.

The increase in the premium limit for the 831(b) election which took effect from January 2017, from $1.2 million to $2.2 million (and now $2.3 million), created an opportunity. Property exposures could be written and underwriting profits rolled over to years where there were substantial losses. If an actuary could show that a reasonable 10-year forecast of a loss was $20 million, for example, a captive could charge $2 million a year to build up reserves.

For earthquake and wind this meant that a captive could be an effective method for commercial property owners to accumulate funds for catastrophic events over many years.

All of the previous reasons for considering a captive are greatly enhanced if this tax treatment can be achieved.

The 831(b) tax election has garnered much attention and great care should be taken to ensure that risk distribution and risk transfer is addressed as well as the premium set before any property owner adopts a captive insurance strategy.

Once a captive is established and functioning efficiently for the above considerations, many owners will start investigating offering coverages such as deposit waiver and or tenant liability to their tenants. Those are a different set of considerations for another article. ●

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