Muhammad bin Ibrahim: De-risking Asia - the growing role of self-insurance

Keynote address by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Asian Captive Conference 2017 "De-Risking Asia: The Growing Role of Self-Insurance" Kuala Lumpur, 16 August 2017.

* * *

It is probably fair to say that captives have had, at best, an uneasy relationship with regulators. Captive insurance did not get off on the right foot with regulators. In the early days of the modern captive, efforts to regulate captives were mostly ill-suited to the nature of the captive business. Prudential and market conduct regulations intended for the protection of the general public were applied equally to traditional and captive insurers. This reduces the cost savings that captives were set up to achieve. In response, captives relocated and domiciled in jurisdictions with less onerous regulations, which on hindsight is an onerous consequence.

Fast-forward half a century, captives are have an entrenched reputation for being tax evasion vehicles of large corporations. Offshore centers that are hosts to many captives have come under greater scrutiny, with stronger tax and regulatory regimes back on the cards to haunt the industry.

We seem to have come full circle, and possibly still without a clear grasp of how captives, as well as the economics in which they operate, have fundamentally changed over time. This raises a risk that the captive and regulatory community may yet find itself caught wrong-footed (again!), with potentially higher stakes at hand.

I thought that it is worth talking about the role of captives in the shifting sands of business in the 21st century. I would like to share some thoughts on what the future holds for captives as we contemplate the changes taking place around us.

Responding to risk in the 21st century – the role of captives

Major risk events often strike without prejudice. Typhoons do not discriminate in the havoc that they wreak. Terrorist attacks affect innocent bystanders who happen to be at the wrong place at the wrong time. Organizations across the globe, no matter what their purpose, have been targeted by cyber-attacks. From the National Health Service in the UK, to schools in China, to chocolate factories in Australia, organizations large and small, for-profit or non-profit, have borne the brunt of ransomware attacks.

Thanks to globalization and advancements in technology, the impact on businesses is also more far-reaching and larger in scale than ever before. The malware WannaCry hit 200,000 computers in 150 countries. Attacks on multinational transport companies based in Europe stranded cargo at ports in India. The losses from these events are large. Cyber theft cost the global economy more than $450 billion in 2016. Lloyd’s of London estimates that a global-scale cyber-attack could rack up losses of $53 billion, similar to a catastrophic natural disaster such as U.S. Superstorm Sandy in 2012.

Unsurprisingly, risk awareness is now growing across the entire spectrum of businesses. The 2017 Allianz Risk Barometer, which covers mainly large corporates, as well as a 2016 Zurich study on SMEs revealed that cyber risk is topmost on businesses’ minds. The same study showed that, in Asia Pacific, there are now twice as many SMEs that worry about cybercrime, fire, technological vulnerabilities, health and safety of customers or employees, and corruption compared to four years ago.

Yet, in terms of preparedness for dealing with risk events, there is a marked disparity between large corporates, and mid-sized and smaller companies. Predictably, larger companies are the ones that tend to have a structured risk mechanism in place, as well as the resources and expertise to deploy risk management tools. Larger companies also tend to have better access to specialist insurance products and the resources to establish a captive. Indeed, 90% of Fortune 1000 companies have a captive insurance company.

Smaller and mid-sized companies are a different story. Most do not consider captives as a feasible risk management option. However, this is changing with innovations in captive models, such as group and rental captives and protected cell companies. It is not only possible for smaller companies to engage captives. A more compelling business case is emerging for the use of captives as small and mid-sized businesses evolve.

Some of the most significant small business trends in the 21st century include disaggregated business networks, shorter cycles of proprietary knowledge, and rising entrepreneurship powered by a younger digital generation. Take for example, high-growth tech startups. As disruptors, their business models and risk profiles, are often unique. Much of their competitive edge is derived from concepts and technologies that are new to the market. Ride-sharing platforms such as Uber and Grab are built on seamless apps that work exactly the same whether in London, New York or Kuala Lumpur.

From an insurance perspective, however, trans-border solutions for such businesses are substantially more complicated. The ride-sharing model combines private vehicles with commercial use. The seamless insurance coverage for Uber drivers that integrates exposures from private and commercial use, and satisfy the mandatory requirements under different domestic laws, are not yet fully developed in all markets. This example calls for bespoke and efficient solutions which may not be readily available in certain traditional insurance markets.

To put this in perspective, Google has projected that Southeast Asia's web-generated business will multiply over 6 times to $200 billion by 2025, from $31 billion in 2015. The massive impact of technology on the world as we know it, will create new insurance gaps and demand for bespoke solutions. This will set the stage for captives to take on a more active role in the risk management ecosystem. Companies that are altering the business landscape will need creative and efficient risk transfer solutions that address their unique business needs.

Used alongside other risk management strategies, including the traditional insurance market, captives allow companies to design an optimal risk transfer structure. For example, more standard risks can be insured in the traditional market while more specific and bespoke risks can be tailored and underwritten by the captive.

The benefits go both ways. Captives can, and should, also contribute significantly to the development of the industries they serve. Insuring with captives enables businesses and economies to better weather insurance market cycles. Especially for smaller and mid-sized companies, captives can be a powerful catalyst for more mature risk management practices and culture. This comes from putting control of a company's insurance needs in its own hands and encouraging a longer-term and more sophisticated view of risk.

The effects also accrue to the wider insurance industry. The captive can act as a 'risk incubator' by recording and accumulating data and information about lesser known risks. In time, this will promote conditions for the development of new products and markets as businesses and solution providers continuously seek out more efficient ways to manage risks.

Future trends – opportunities and changing norms for captives

What the future holds for captives. Three trends are worth noting.

First, captives are poised to move beyond the predominant focus on the single parent-captive model and the exclusive domain of large corporates. In fact, many non-profits entities in the US, and an increasing number of SMEs are accessing captives via group captive models that pool assets and share risks across its members.

Parallels can be drawn with the mutual, which also shares similarities to takaful (Islamic insurance). During the 1700s and 1800s, the earlier forms of captives were mutual insurers, formed together by firms from a particular industry that shared similar exposures.

Today, mutual models are still very much alive. Their contributions to global premiums have risen in recent years after years of decline, and they include captives set up as mutuals. The takaful industry is also thriving and poised to continue growing, in large part driven by growth in Asia.

The overlapping markets of the mutual, captive and takaful industries, is likely to provide an important impetus for the wider use of group captives among mid-sized and smaller companies. This region is especially well-placed to harness this potential, given the vibrance of SMEs and fast growing takaful market. Southeast Asia alone contributes almost 30% to global takaful contributions, and this offers an opportunity, as Malaysia has long sought to develop a facilitative regulatory environment to drive an innovative, competitive and sustainable growth of Islamic finance.

Second, technology will be a key driver and opportunity for new captive models. Technological advancements are already driving the growth of captive insurance business due to the new risks that businesses face. As an industry founded in response to an inflexible insurance market, the history of captives is very much intertwined with innovation. The first captive can itself be seen as a disruption to the market!

Captives can be expected to leverage on new technologies to modernise legacy processes and systems, strengthen risk management capabilities and capture efficiency gains.

At the frontier of development, the evolution of Big Data and Insurtech has opened up significant new possibilities for segmenting and pooling of risk and capital, and tailoring solutions to specific needs and profiles.

Online platforms based on the group captive model and P2P insurance concepts are a case in point. Given that captives aim to provide specialised coverage that is not typically available in the traditional market, it is only natural for captives to operate in this space.

Third, we are likely to see greater traction in efforts to understand captives from a regulatory and supervisory perspective. At a global level, there is a greater appreciation of the role and importance of captive insurers, including by the International Association of Insurance Supervisors (IAIS). IAIS published two papers in 2006 and 2015, addressing the economic benefits of captive insurance and its relationship to traditional insurance and reinsurance markets. More significantly, it recognizes the importance of applying a supervisory regime that has due regard to the specific nature, scale and complexity of various forms of captives.

A primary objective of regulation for captives is promoting financial stability. In this respect, regulators will continue to be concerned with risks that may be created as a result of arbitrage and distortions to the broader insurance market. Captives have an important contribution to offer. However, understanding risks relating to captives at a much deeper level, will be important to deliver regulatory outcomes that are proportionate and economically efficient.

Captive risks will differ from traditional insurance, and they also vary significantly between different types of captives, depending on ownership and structure, scope of business and nature of risks insured.

Managing these risks cannot simply be addressed at an institutional level. Macroprudential measures might have relevance in certain circumstances. For example, a pure captive insurer that merely underwrites the risks of its parent may pose low financial and consumer risks, but if the parent is an economically significant entity, with critical financial linkages, a different regulatory response and approach might be warranted.

To a large extent, our ability to design suitable regulatory frameworks for captives remains constrained by the paucity of data on captives. This needs to be addressed as a matter of priority. Broader measures need to be taken, both at a national and global level, to collect better data on captives to understand their nature, evolution and impact on macro-financial developments.

Increased efforts by governments to tackle profit shifting and tax base erosion (BEPS) have been another factor behind recent regulatory developments. Significant changes have taken place affecting offshore financial centers in the past decade, shaped by heightened expectations for enhanced transparency and exchange of information between tax authorities.

These winds of change are likely to pick up speed for captives. And they will change the way captives have operated in the past. Very likely it would pave the way for the transformation of offshore financial centers. Captives could metaphorsise from perceived brass plates models into legitimate commercial vehicles that serve a real economic purpose. Perception management is pivotal for the future existence of captives.

Captives must be seen as supporting and contributing to the broader economic transformation and growth.

These three developments; the emergence of more diverse captive models serving a broader spectrum of companies, technological advancements and more considered regulations, are likely to foster a greater convergence between the intended economic outcomes of captives, and the required and appropriate regulatory framework. I hope that this forum will seize the window of opportunity to bring together mutual interests that have long been somewhat at odds.

As a collective, all of us here today, have a common interest in ensuring that captives demonstrate genuine value and valuable economic purpose. Achieving this calls for strong corporate governance practices, greater transparency and sound financial management that commensurate with underwritten risks.

Ultimately, a new reality needs to be embraced by captives. In the long term, investing in technology, technical expertise, better and stronger compliance frameworks are worthwhile endeavors. It’s no more a choice.

At stake is the viability of individual captives and an enduring captive industry that will add breadth and depth to insurance markets.

Conclusion

The captive industry may well be at a turning point. In moving forward, how we start matters. Efforts to develop the captive industry should be focused on better risk management, promoting macro-economic stability and encouraging new growth rather purely concentrated on tax planning.

There are promising signs, among business and regulatory sectors, that there is a growing space for captives to play a role. It is important that we move forward to harness this potential, responsibly and thoughtfully.