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Growing Role of Japanese Captives

Room for growth for Japanese captives.

Japan's economy is the third largest globally. With large-scale advanced industrial sectors in the domestic market, Japan's commercial insurance market amounts to about USD 36 billion, which also is the third largest market in the world, according to Swiss Re's research.

While both large and small corporations in the West have embraced captive insurance solutions over the last few decades, this evolution has been decidedly slower in Japan. It is estimated that most, if not all, of the Fortune 500 companies in the U.S. have at least one captive insurer.

The low utilization in Japan is partly due to historically strong relationships with the major domestic insurance groups, which have been the largest shareholders of the industrial organizations. However, these relationships have evolved in recent years as evidenced by the continuous reduction in business-related stock holdings by the major Japanese insurance groups. This decline would suggest that there may be additional Japanese captives in the future. This growth would be particularly timely as many companies are investing in or starting new subsidiaries outside of Japan.

For further captive usage to occur, senior management, including chief risk officers, would need to be educated about the many risks and benefits that a captive provides. This information would likely come from the many captive regulators in the pertinent domiciles, along with the related service providers to the captive industry. The infrastructure in these domiciles includes captive managers, actuaries, accountants, and consultants who help design, price, and monitor captive performance.

In this respect, the domicile is a key factor for captives' expansion. Bermuda and Hawaii, which have long histories of captive operations, remain the popular domiciles for Japanese captives. However, a few domiciles in the Asia-Pacific region have gained traction among the Japanese captives. In particular, Federated States of Micronesia (FSM), a relatively new domicile in the Asia-Pacific region, has attracted Japanese captives. Since the first captive was set up in 2009, the number has grown to 18 captives in 2016. In addition to geographic proximity, favorable regulations toward Japanese companies such as by offering usage of Japanese language and Japanese currency attracted the captives.

Challenging Operating Environment

The universe of rated single parent captives both in Japan and elsewhere around the world has weathered the challenging market conditions in recent years. Some have been impacted by the weakening credit profile of their parent companies given the downturn in global economic conditions. Despite market conditions, captives act as a tool for risk management departments. When market conditions harden, captives expand their risk-bearing. In contrast, when conditions soften, as evidenced in the last few years, captive managers strategically utilize the commercial markets with less business retained in the captive. In fact, business retained by the captive is usually more predictable and naturally more profitable. One challenge for the Japanese captives has been the inclusion of new lines of business associated with the parent's business expansion. Monitoring the performance of this business against the parent's operating challenges will continue to be an issue for many risk management departments. As expansion has occurred, most, if not all, of the third party business has been

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with companies with which the captive owner has a business relationship. While unaffiliated, the captive can still apply the appropriate risk management principles to this business.

One issue to note is the risk associated with expansion. A rated Japanese captive owned by a large trading company that expands into new risks such as energy and engineering projects assumes the risks of the parent and affiliates. Although overall retained risks remain very limited, these risk profiles are described as low frequency but high severity, which could pose potential volatility in captives' operating performance without appropriate retrocession arrangements.

The investment portfolios of the captives are yield-challenged just like those of the commercial market carriers. Liquidity is paramount for captives to support prompt claims payment given their role of fronting the parent risks with a number of (re)insurers. As such, investment portfolios consist mainly of highly liquid assets such as cash or short-term deposits and investment income has a limited contribution to overall returns amid the low-rate environment. On the other hand, a few of the rated captives have managed their capital efficiently in search of yields by offering a loan-back program to the parent through the group's liquidity management program. This loan-back to a parent is regarded as a preferable option compared to an investment in external markets that could bring additional volatility in performance. However, it is worth noting that the loan-back could result in higher concentration risk to a captive's balance sheet if the parent's credit profile weakens.

ERM Highlights for A.M. Best Rated Japanese Captives

In recent years, A.M Best has expanded its analysis of a rated company's Enterprise Risk Management (ERM). The rated Japanese captives' ERM process is less comprehensive compared to commercial insurers as the captives have a more limited scope of operations through their participation in the insurance program for the parent companies. However, the evaluations suggest that overall risk capabilities of the rated Japanese captives are fairly matched to their risk profiles although there remain variations across captives.

As a single parent captive focused on parent business, concentration risk is higher relative to their risk management capabilities. Although the rated Japanese captives expanded risks moderately, most premium income is concentrated into one or two lines of insurance that cover the parent risks.

The rated Japanese captives face relatively high risk associated with reinsurance schemes given their low retention. In this respect, the parent's financial strength is analyzed together to determine whether the group would be able to withstand the adverse impact that the captive experiences from a sharp increase in counterparty risk under a stress scenario. Although some

Exhibit 1
Risk Profile vs. Risk Management Capability
Rated Japanese Captives

Risk Category	Product / Underwriting	Reserving	Concentration	Reinsurance	Financial Flexibility	Investments	Legislative / Regulatory / Judicial / Economic	Management	Operational	Risk Appetite / Stress Testing	Summary
Risk Profile	5	5	6	7	4	4	5	5	5	5	5
Management Capability	5	5	5	7	5	4	5	5	5	5	5

Note - The scores range from 1 (low risk profile or low risk management capability) to 9 (high risk profile or high risk management capability).
Source: A.M. Best data and research

of the parent companies across the industry have lower liquidity and weaker financial strength, currently the rated captive's financial health would still support their risk profile.

The rated Japanese captives have strong financial flexibility, as evidenced by the historical support from the parent companies, such as through capital injections or a reduction in dividend payouts to the parent as needed. As access to additional capital from the parent takes a key role for the captive to preserve capital, the parent companies' liquidity position and financial strength are monitored together to assess capitalization. However, continued downward pressure on the parent's credit profile in some cases could lead to an erosion of captive's capital through a potential higher demand on dividend payouts.

Summary

The rated Japanese captives currently face an increasing challenge due to the weakening credit profiles of the parent companies. Although parent profile is not a sole factor in assessing the creditworthiness of the captive, this factor is increasingly putting downward pressure on the ratings of captives given their main purpose of managing the risks of captive owners.

Over recent years, captive operations have been further integrated into the parents' risk management scheme by serving more insurance needs for the parents. Although the rated captives could not meet all the needs of the owners, such as newly emerging risks like cyber risk, the rated captives have made the gradual expansion in risk within their risk management capabilities. Their enhanced risk management capabilities and growing position as a part of the parent's overall risk strategy ensures their strategic importance going forward.

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