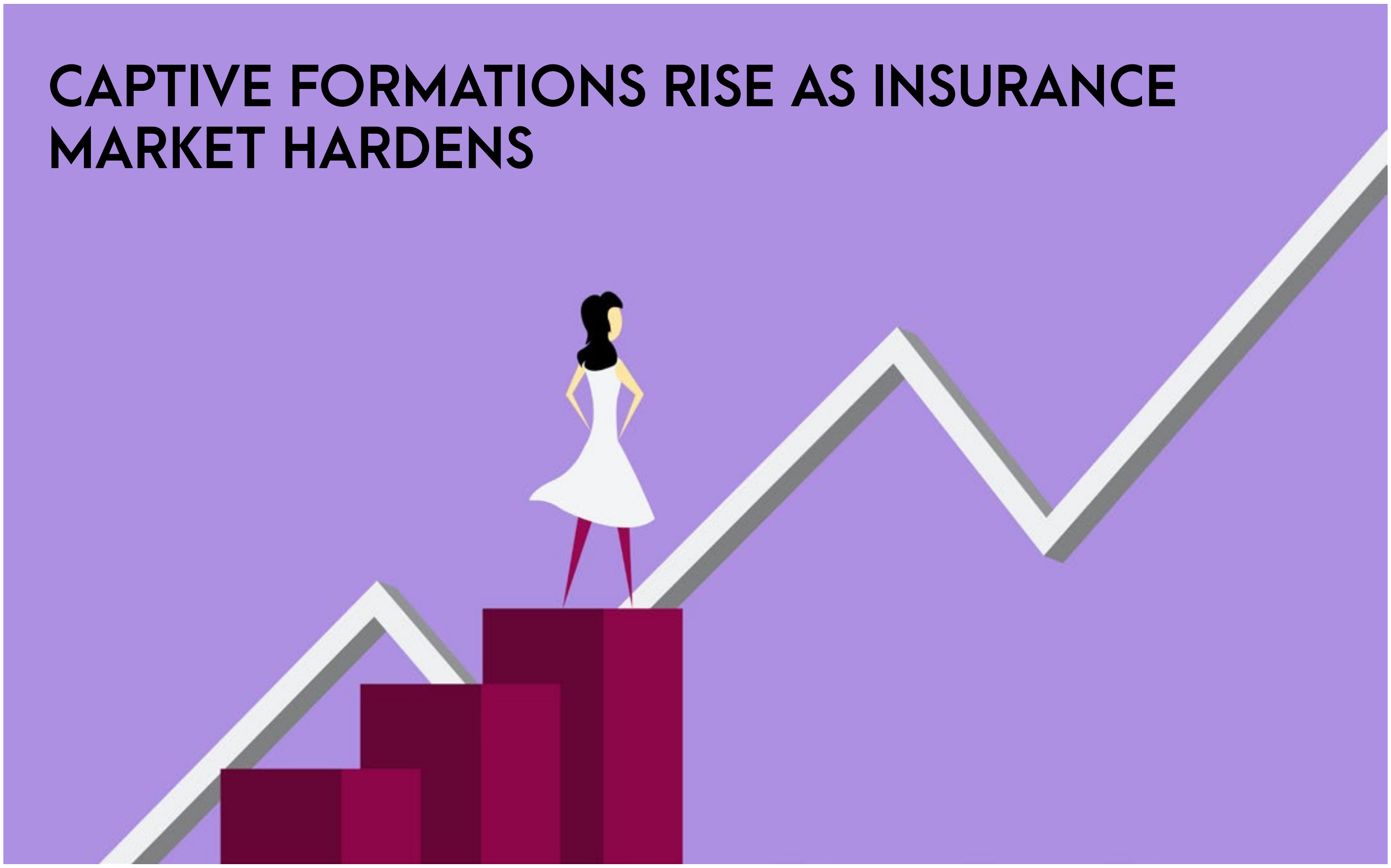
CAPTIVE FORMATIONS RISE AS INSURANCE MARKET HARDENS



Written By Caroline McDonald

The current economy's rise and fall has meant accelerated risks for businesses., including supply chain disruption, workplace staffing issues and cyber hacks; and massive property and infrastructure damage caused by storms, floods and wildfires.

As a result, the insurance market is hardening across a diverse and increasing set of risk areas.

This market, as well as a variety of emerging risk, has meant accelerated growth of captives, as well as a normalization of the concept of captive insurance in general. This evolution has increased the need for captives as an economical way to fill coverage gaps and add control and flexibility to the management of difficult risks.

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"The continued hardening market and investment volatility has helped propel an interest from businesses of all sizes in leveraging captives to insure many types of coverages, as a solution to risk management needs for controlling costs and providing customization of coverages,"

said Jason Tyson, communications director of the North Carolina Department of Insurance.

He added, "All indications signify that 2023 will be another year of growth for North Carolina's captive insurance industry, as companies of all sizes seek increased flexibility and lower costs while managing their risk profiles in the hardening market."

Vermont, the largest domicile in the U.S., said in a statement, "The growth in captive formations in 2022 is Vermont's 6th highest year of growth in its over 40-year history since passing captive-enabling legislation in 1981."

Joe Holahan, partner at Morris, Manning & Martin, LLP, and president of the Captive Insurance Council of the District of Columbia noted that D.C. licensed 25 captives in 2022, "Which was a fairly big year for D.C." He added, "We've formed five captives, so we're looking good for 2023."

CELL CAPTIVES TAKING OFF

Cell captives top the list of new formations across a number of domiciles, which have increased in popularity for several reasons.

"There are a few things going on with them," Holahan said. "One is with new formations. Owners see joining an existing cell facility as being the convenient way to get the captive up-and-running."

He is also seeing clients opting to form a cell captive, "even when they don't have an immediate need for a cell, with the idea that they may have some plans in the future to form cells for different purposes. It allows a level of versatility that is attractive to them," Holahan said.

Being with a sponsored facility, he explained, "is a turnkey solution for services. You have an auditor lined up for your annual audit, and actuarial support to prepare an annual actuarial opinion. Everything is wrapped into a convenient package."

Tennessee is seeing is a big interest in cell structures as well.

"We are coming close to our 1,000th captive, and a good number of those are cell entities,"

observed Mark Wiedeman, director of the Tennessee Department of Commerce and Insurance's captive insurance sector.

Similarly, Vermont said its 59 sponsored cell captives currently host more than 500 cells and separate accounts, in addition to the licensed captive companies.

In North Carolina, the Department of Insurance approved more than 100 cell captives in 2022, "and we anticipate the trend of new cell formations to carry through 2023," Tyson noted.

"This structure can be used as a cost savings method and to fill gaps in coverage, while creating value for businesses that maintain strong loss-prevention programs."

Looking ahead, Tyson said, "All indications signify that 2023 will be another year of growth for North Carolina's captive insurance industry, as companies of all sizes seek increased flexibility and lower costs while managing their risk profiles in the hardening market."

GROWING USES FOR CAPTIVES

One risk that is increasing the formation of captives is cyber insurance. "There is interest in using a captive because that market has turned very hard," Holahan explained. "Insureds are keeping larger and larger retentions, so that is driving a lot of interest in using a captive to finance that self-insured risk."

Another reason, he said, is "a shakeout in the market in the last few years, when ransomware attacks exploded, which put a lot of pressure on capacity and rates in the cyber insurance market."

As of January 2022, Vermont stated new captives were licensed in 17 different industries, the top three being healthcare (7), construction (5), and real estate (4).

In North Carolina, "We have recently seen an uptick in captives writing medical stop loss, tenant liability, and various cyber security coverages," Tyson said.

FEDERAL OVERSIGHT

In Montana, "We're still seeing some 831(b) captives, but we've also seen a lot of 831(b) captives dissolve, which I believe is from increased scrutiny of the Internal Revenue Service." The IRS keeps a watchful eye on 831(b) captives, "because of a few captives in the past that were formed for purposes other than insurance, such as trusts," said John Huth, chairperson of the Montana Captive Insurance Association and an independent captive director.

Wiedeman said that on the federal level, Tennessee keeps track of IRS guidance and rulings that could impact captives. From a state perspective, he added, a captive's tax status is not regulated.

In D.C., "We're always talking with the insurance department here about ways to improve the authorizing legislation for captives, but it's extremely flexible now," Holahan said. He added that if there are allowances in other jurisdictions, "the department has the discretion to allow those things in D.C. It gives regulators a lot of flexibility."

TRENDS

As for trends, "One that I have seen is more and more insuretech industries interested in forming a captive, particularly an agency captive," Holahan said. The driver there is, "if it's a managing general agent, it helps attract the capacity if they take the risk in their own captive program." Taking the risk shows that,

"They believe in their underwriting model and they're willing to take on risk for the program, which is attractive to insurers, reinsurers and investors."

Insurtech can mean a number of things, but in this context, he explained, it refers to a group that has automated or may be using various technologies to improve their underwriting process. It can be used to process claims, evaluate risk, process contracts, or underwrite policies.

"I've seen more and more insuretechs form captives because it allows them to capture some of the underwriting profit that they're writing, and it makes for a compelling case when they are pitching new partners," Holahan said.

All in all, if 2022 is any indicator, 2023 will be a continuance of the upward trend of captive formations.■

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DOMICILES SEEING CONTINUED GROWTH IN 2022

Captive growth over the past year has been reported in a number of domiciles, including the following:

- Vermont had 620 captives in 2021 and licensed 41 new captive insurance companies in 2022.
- North Carolina's total was 257 captives in 2021 and that number reached 294 by the end of 2022.
- In Montana, growth has been steady, with 261 captives in 2021 and 268 by the end of 2022.
- The District of Columbia had a total of 175 active captives at year-end 2021. It licensed 25 new captives in 2022 and terminated 9, for a net increase of 16 active captives totaling 191 in 2022.
- In Tennessee the 2021 total was 148 captives. In 2022 there were 13 new captives and 11 surrendered licenses, for a year-end total of 150.
- Utah had 384 formations in 2021 and 419 in 2022.
- Hawaii saw 251 total formations in 2021 and 255 in 2022.
- South Carolina totaled 181 formations in 2021 and 208 in 2022.