CAPTIVE INSURANCE FACES WIDESPREAD REGULATORY CHANGES

Emerging trends forecast an eventful 2023

Written By Laura Carabello

Government regulation is one topic that tests the mettle of chief compliance officers and general counsel at captive insurance companies nationwide. Looking at the current regulatory environment and what will quickly unfold in 2023 and remembering that a captive is self-financing of risk, the proliferation of state and federal regulations often challenges the most experienced industry leaders.

Leading analysts and consultants forecast numerous areas that require attention, with consensus on several key topics that merit particular consideration in this trends review.

CLIMATE AND SUSTAINABILITY

In the area of Environmental, Social and Governance (ESG), captives can expect sweeping regulatory changes that are likely to continue into 2023 under existing and expanded jurisdictional authority. They will remain a central focus for regulators as Federal financial agencies develop and execute strategies to quantify, disclose and mitigate the financial risk of climate change on public and private assets.

Although the past few years have seen regulators and standard-setters attempt to better understand these multidimensional issues and their economic and societal impacts, additional regulatory clarity is expected in the years ahead.

KPMG advises that the associated challenges are not easy to navigate and will require a concerted response from all stakeholders to avoid unintended consequences: "Public policy seeks to advance consistent, clear, intelligible, comparable, and accurate disclosure of climate related financial risk," and "to mitigate that risk and its drivers, while accounting for addressing disparate impacts on disadvantaged communities and communities of color."

ROLE OF CAPTIVES

Experts at *Business Insurance* (March 2022) believe that captives can help to formulate a strategy, provide funding for ESG activities and use these issues to help secure reinsurance capacity.

Fueled largely by significant and widespread investor demand and facilitated by pressures from regulators, investors, activists and others, they say corporations and their captive insurance partners must be seen to be working to identify and report what they are doing on ESG initiatives. Today, captive companies are striving to better measure, monitor and mitigate climate-related risk.

"The biggest risk about ESG is ignoring it," said Michael Douglas, Newtown Grant, Pennsylvania-based director of business development for Aon PLC's captive management operations. Douglas points to the role of captives, which are designed to solve problems for their parent companies, as well-positioned to act as a focal point to identify ESG issues and implement and document a company's strategy for addressing them.

According to Karen Hsi, program manager-captive insurance programs for the University of California, office of the president, in Oakland, California, US insurers are less concerned about ESG issues than European insurers and reinsurers. However, she says captive surpluses can also be used for various environmental infrastructure projects, such as installing solar panels on buildings,

Insurance industry regulators in the US have been proactively reviewing existing supervisory tools that might be applicable. At the same time, they have been seeking to identify and understand what new tools, standards and guidance might also be needed.

The US Department of the Treasury, through the Federal Insurance Office (FIO), announced its own response to President Biden's May 2021 executive order on climate change. Specifically, in August 2021, it issued a request for information to solicit public feedback on the FIO's future work on climate-related financial risks in the insurance sector.

Going forward, FIO is likely to continue assessing the impacts of climate change on the US insurance industry, with a focus on the sector's financial stability and on market vulnerabilities, especially for minorities and low-income communities. Although the FIO is not a regulator, the information it collects can help inform and shape regulatory policy development both domestically and internationally – and this will impact the captive industry.

CRYPTOCURRENCY, DIGITAL ASSETS OR 'VIRTUAL CURRENCY'

The digital asset ecosystem is growing in scope and complexity, including innovations such as blockchain and cryptocurrency, triggering regulatory concerns about customer protection, economic loss and consumer education.

Last year, the *Wall Street Journal*, among other media, reported the Security and Exchange Commission Chairman Gary Gensler called for more investor protection in crypto and compared the cryptocurrency market to the Wild West: "What is needed is more active policing of crypto trading and lending platforms, as well as so-called stablecoins…this asset class is rife with fraud, scams and abuse."

In fact, Reuters reports that in July 2022, issuers of so-called "stablecoins," virtual currencies whose value is pegged to traditional currencies, would face bank-like regulation and oversight under a draft bill from senior U.S. House lawmakers.

Increased regulations and scrutiny reflect the well-publicized collapse and anxieties experienced by some prominent stablecoin issuers in recent months. Regulators seem to be very concerned that consumers could be harmed.

But it appears that a single framework of rules guiding oversight of the space has stalled, as the House Financial Services Committee charged with issuing draft legislation on the subject delayed decision-making.

However, this pause has not stopped regulators from using existing regulations in attempts to govern digital assets while the Justice Department (DOJ) and SEC are investigating entities for insider trading, regulatory compliance and information security aspects of certain assets.

AMWINS®
GROUP BENEFITS

amwins.com

The benefits landscape is broad and complex.

Skyrocketing prices. Administrative challenges. Shock claims. Aging workforces. At Amwins Group Benefits, we're here to answer the call. We provide solutions to help your clients manage costs and take care of their people. So whether you need a partner for the day-to-day or a problem solver for the complex, our goal is simple: whenever you think of group benefits, you think of us.

Bring on the future – we'll cover it.

Congressional gridlock during the midterm election season may delay this further, but regulatory guidance and legislative changes are certainly on the near horizon.

Beyond this volatile environment, Mercer suggests that captive insurers look at other related issues, including whether or not to accept digital assets as forms of payment or to actually take ownership of these assets in their private portfolios.

Considerations such as exposure related to theft or loss of such assets that may not have been priced can be problematic. There may actually be a market to help provide protection of these assets. Finally, firms will need to determine the best way to implement any of these efforts.

Integrating a digital asset strategy into existing compliance programs is a must-have, recommends KPMG, advising captives to develop a corporate/product capability assessment and risk and compliance strategy for the appropriate licensing, issuance and/or use of digital assets.

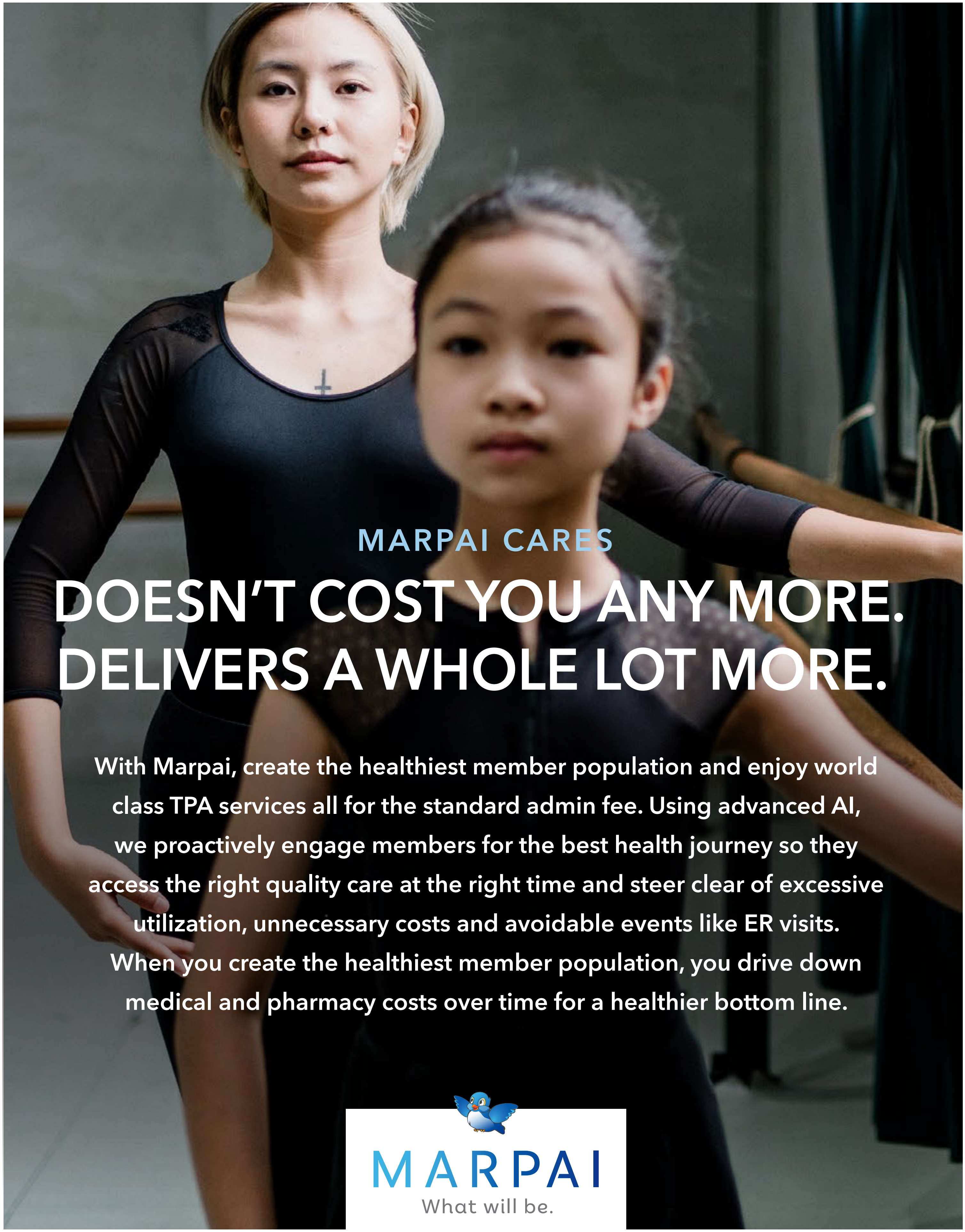
Going forward, this will be especially important as the IRS is instituting reporting requirements for cryptocurrency and other digital asset transactions beginning in 2023.

PRIVACY AND CYBERSECURITY

Cybersecurity is turning into a social phenomenon, asserts the Gartner Group, as cyberattacks have earned high priority status among US regulators amid the rising incidence of cyberattacks and the growing number of high-profile data breaches associated with malware (e.g., ransomware), supply chain risk and sophisticated Distributed Denial-of-Service (DDoS) attack.

Amid the flurry of regulatory attention to cyber and data issues in 2022, focused attention is now placed on customer data privacy and protection.

The term "Privacy by Design" was first coined in the 1970s by Ann Cavoukian, Ph.D. Information & Privacy Commissioner, Ontario, Canada, and simply means data protection through



www.MarpaiHealth.com

technology design and setting a baseline for robust data protection by embedding privacy into the design, operation, and management of new applications -- including IT systems, AI platforms, and digital business practices, with the goal of preventing privacy vulnerabilities.

The concept is that data protection in data processing procedures is best adhered to when it is already integrated in the technology at the time it was created.

Regulatory response to cybersecurity breaches has been swift. April 2022 marked the one-year anniversary of Executive Order 14208, requiring improvements in the cybersecurity of the United States, including the creation of standards, supply chain security, standard responses to cyber incidents and the creation of a Cybersecurity Safety Review Board (CSRB).

Today, stepped-up government scrutiny of cybersecurity is evident, with increasing calls for regulation to address the numerous risks posed by a cyberattack, including – according to the National Association of Insurance Commissioners (NAIC) -- but not limited to:

- Identity theft
- Business interruption
- Damage to reputation
- Data repair costs
- Theft of customer lists or trade secrets
- Hardware and software repair costs
- Credit monitoring services for impacted consumers
- Litigation costs

It is expected that the complex regulatory environment will endure in 2023, particularly around the growing adoption of the NAIC Insurance Data Security Model Law (#668), which seeks to establish data security standards for regulators and insurers in order to mitigate the potential damage of a data breach.

Relevant to the captive insurance space is a patchwork quilt of state-based requirements that creates a multifaceted operating, risk and compliance environment as the law applies to insurers, insurance agents and other entities licensed by the state department of insurance.

Model 668 has been adopted in the following 21 states as of June 2022: AL, AK, CT, DE, HI, IA, KY, LA, ME, MD, MI, MN, MS, NH, ND, OH, SC, TN, VT, VA, and WI. While the purpose and intent of this law is to establish standards for data security and address how insurers and licensees protect personal information, it does not provide sufficient guidance regarding penalties that should be imposed by regulators for violations.

The healthcare sector is particularly vulnerable to assaults, with one firm (Sophos) reporting that ransomware attacks on healthcare organizations increased 94% from 2021 to 2022. The criminality of cyber-attacks is acknowledged, with reporting by the International Criminal Police Organization (INTERPOL) showing an alarming rate of cyber-attacks during the pandemic and a significant target shift from individuals and small businesses to major corporations, governments, and critical infrastructure.

Implementing risk mitigation and resilience initiatives relative to both the frequency and impact of cyber threats indicate the growing extent of current or emerging threats to the captive industry.

New Federal Financial Institutions Examination Council's (FFIEC) guidance outlines effective risk management principles and practices for access and authentication, including:

- Monitoring, logging, and reporting of activities to identify, track, respond, and investigate attempted or realized unauthorized activities.

- Layered security and multiple controls to compensate for the weakness of a single control; multi-factor authentication may protect accounts from being compromised by threats, such as credential stuffing, phishing attacks, and spear-fishing attacks.

- Access and transaction controls, including account maintenance; transaction value, frequency, and timing; rate limits on log-in attempts; and application timeouts.

- Authentication solutions are employed before system access, including solutions such as device-based public key infrastructure (PKI) authentication, one-time passwords (OTP), behavioral biometrics software, and device identification and enrollment.

DIGITIZED TRANSFORMATION AND COMMUNICATIONS

While some insurers increasingly interact with stakeholders via automated, digital communications and may be starting to utilize digital technologies to improve

their compliance programs, insurer transformation to a digital approach is still in its early stages.

But this hasn't held back regulators from raising red flags about various aspects of digitized communications and transactions. KPMG Advisory forecasts regulatory attention on data and privacy that are expected to include:

- Proposed rulemaking from the Consumer Financial Protection Bureau (CFPB) to facilitate the portability of consumer financial transaction data and a review of Big Tech practices related to consumer data capture, use, and restrictions in the context of their payments systems.
- An FTC rulemaking addressing unfair data collection and surveillance practices impacting competition, consumer autonomy, and consumer privacy.
- SEC focus on investor protections, predictive data analytics and digital engagement practices.
- Expansion of state data privacy and protection laws.

Digital interaction with customers will require insurers to source, hold, and use data that is often extremely sensitive – including health Personal Health Information, health-related data and claims payments.

An abundance of customer-facing portals and the implementation of advanced modeling techniques, coupled with some nefarious ransomware gangs honing their targets, point to trends that are raising regulators' eyebrows about whether data use is, according to Deloitte, "…fair and impartial, transparent and explainable, responsible and accountable, robust and reliable, safe and secure, and respectful of privacy."

The use of data is fraught with multiple concerns around ethics, discrimination and permission to actually use the data.

Many state regulations, including the California Consumer Privacy Act (CCPA), feature elements of permission and preference, while the New York State Department of Financial Services (NYDFS) and the Department of Labor have issued data-related cybersecurity guidance that extends to third parties.

Ensuring that data is protected and properly classified by the insurer and all affiliated parties is critical for complying with state and federal regulators.

FORM 5500 UPDATE

According to the Department of Labor (DOL) website, the DOL has announced its alignment with the IRS and Pension Benefit Guaranty Corporation (PBGC) to release a Federal Register Notice announcing changes to the Form 5500 Annual Return/ Report of Employee Benefit Plan and Form 5500-SF Short Form Annual Return/ Report of Employee Benefit Plan, and related instructions, that apply beginning with 2022 plan year reports.

The Notice focuses mainly on improvements in reporting on the actuarial and retirement plan schedules (Schedules MB, SB, and R) filed by defined benefit pension plans subject to Title IV of the Employee Retirement Income Security Act of 1974.

There are several significant changes, including a new group filing alternative for certain single-employer Direct Contribution plans and a new schedule for multiple-employer plan reporting.

Mintz law firm advises that in a group captive, each participating employer maintains its own self-funded group health plan and stop-loss coverage is purchased from a commercial medical stop-loss carrier that cedes a portion of the risk to a group captive insurer.

Many mid-sized employers can self-fund health benefits but interpose a separate layer of stop-loss coverage under a "group captive" arrangement that includes other, similarly situated employers. If the stop-loss policy is a plan asset, then it must be reported as such on a schedule to the plan's annual report -- Form 5500.

Filings for the 2022 plan year generally are not due until seven months after the end of the 2022 plan year, e.g., July 31, 2023, for calendar year plans, and a 2½-month extension is available by filing IRS Form 5558, Application for Extension of Time to File Certain Employee Plan Returns, on or before the normal due date.

D&O COVERAGE: DELAWARE IN THE SPOTLIGHT

The American Bar Association headlines this significant news: January 27, 2022, the Delaware Legislature passed legislation designed to make captive insurance a viable alternative to traditional D&O insurance. This new development should mean that, over time, the cost of D&O insurance should decline.

It appears that while a corporation with a small balance sheet wanted to purchase D&O insurance, why were corporations with hefty balance sheets buying this insurance, often referred to as Side B/C coverage, instead of simply self-funding losses?

Some of the answers can be found in *Business Law Today* (https://businesslawtoday.org/2022/02/do-game-changer-delaware-approves-using-captives-for-do-insurance/) where legal analysts tackle the issues in detail.

Under Delaware General Corporation Law (DGCL) Section 145(b), corporations are not permitted to provide indemnification for breach of fiduciary duty suits brought derivatively.

“This explains the popularity of “Side A” D&O insurance even for very large, well-funded companies. Side A D&O insurance provides first dollar coverage when something is insurable but not indemnifiable, such as the settlement of derivative suit claims.”

The reason the cost of D&O insurance has gone up so dramatically, they say, is that losses have been outpacing premiums for years. The volatile, high-severity nature of outcomes for D&O claims makes underwriting a particularly difficult challenge—especially for the biggest companies.

Montana Captive Insurance Regulator Steve Matthews reviewed the D&O coverage issues impacting Delaware and reports some interesting findings.

"First, I found it interesting that the law change appeared to be primarily in Delaware's corporate law vs. the captive insurance code.   Given the number of corporations in Delaware, it probably makes sense. But in Montana, our domestic captive companies could provide the coverage if it was not prohibited by the parent company's corporate domicile."

Matthews makes it clear that any advice he would offer regarding D&O coverage is similar to the advice he would give to anyone that is looking to a captive to make them whole. "First and foremost, do your homework. Is the captive properly funded, who decides if/when claims are paid, and what happens to the coverage if the parent company becomes financially troubled?"

The bottom line is that the change just passed by the Delaware legislature amends DGCL Section 145(b), to clarify that as the term is used by the DGCL, the definition of insurance includes captives.

This makes captives a viable alternative to traditional D&O insurance, even Side A D&O insurance, for claims that are not directly indemnifiable by the corporation due to DGCL Section 145(b).

Companies that are the best candidates to use a captive as an alternative to D&O insurance should reflect a strong corporate balance sheet and the desire to retain significant, unpredictable D&O risk.

Corporations using their captive to cover D&O risk should expect to deposit sufficient risk capital into the captive to satisfy regulatory capital requirements and cover claims beyond the actuaries' estimates up to the full policy limit.

These issues created by the Delaware legislation are generating attention in many states. Lori Gorman, Deputy Commissioner, North Carolina Department of Insurance reports that North Carolina captive insurers have had the opportunity to write D&O coverages from Day 1, with the passage of the Captive Insurance Act in 2013.

Recently, however, she says that obtaining this coverage, including Side A (or protection of directors' and officers' personal assets), has become an industry focus.

"This has gained significance with the shift toward greater individual accountability in corporate wrongdoing," she explains. "As a result of this shift, qualified individuals may be hesitant to serve on governing boards without this protection against litigation risk."

Even as D&O coverages have gained importance in risk management practices, recent large settlements for breach of duty and oversight, along with inflation, have contributed to more costly pricing and difficulty obtaining this type of insurance in the traditional marketplace.

"The strategic use of captives can assist both public and private companies of all sizes in meeting the challenges of capacity and pricing as our economy continues to recover from the impact of the COVID-19 pandemic," says Gorman.

Looking at the advice from Marsh and McLennan, captives are a natural option when companies face capacity and pricing challenges, especially when commercial pricing is viewed to be higher than the perceived risk.

"Using a captive to provide D&O insurance has been limited to date and has involved mainly Side B and C coverage. The primary reason for the lack of captive involvement has been the abundance of capacity in the traditional market, available at a low cost. In addition, there is a concern that the use of a captive is not appropriate for the provision of Side A D&O (non-indemnifiable loss) due to the potential for conflicts to arise and questions surrounding bankruptcy remoteness and potential indemnification issues."

BUSINESS OUTLOOK FOR CAPTIVES

Putting aside the regulatory issues, Steve Matthews foresees an increase in the amount of program-type business coming into captives. From his perspective, Managing General Agents (MGAs) and producers are forming captives to participate in the program risk they have developed.

HOMESTEAD
SMART HEALTH PLANS

info@homesteadplans.com • homesteadplans.com

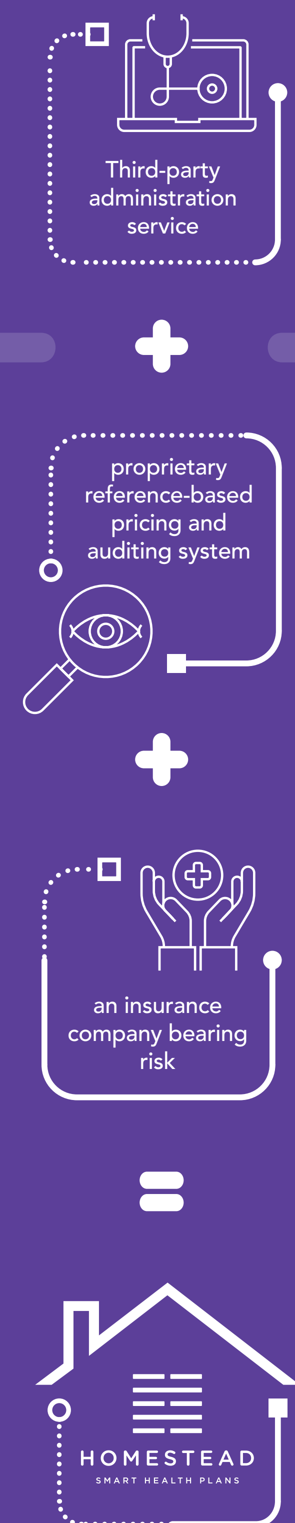
INTEGRATION. TRANSPARENCY. PARTNERSHIP. MEMBER EXPERIENCE.

Everything but the kitchen sink.

We know the current health benefits system is broken. At Homestead Smart Health Plans, we don't just spend time talking about the problem—we deliver the products and services that fix it, **all under one roof.**

Don't settle for a traditional health benefits plan

What are you waiting for?



"Our reinsurance captive is a perfect vehicle to accommodate these transactions," he explains. "As regulators, we are comfortable with these transactions since the policies are written by admitted insurers with a portion of the risk then ceded to the captive. The captive becomes an unauthorized reinsurer of the admitted carrier and required to post collateral to secure payment to the admitted carrier."

Laura Carabello holds a degree in Journalism from the Newhouse School of Communications at Syracuse University, is a recognized expert in medical travel, and is a widely published writer on healthcare issues. She is a Principal at CPR Strategic Marketing Communications.

Sources

https://www.dandodiary.com/2022/01/articles/d-o-insurance/rare-do-insurer-win-in-delaware-court-but-should-do-insurers-celebrate/

https://www.eisneramper.com/about-us/

https://www.dol.gov/newsroom/releases/ebsa/ebsa20220520

www.marsh.com

https://businesslawtoday.org/2022/02/do-game-changer-delaware-approves-using-captives-for-do-insurance/

https://www.irs.gov/newsroom/us-court-of-appeals-ruling-affirms-irs-position-that-abusive-microcaptive-insurance-transactions-are-shams

https://bit.ly/3AT4Qqc

https://www.mintz.com/why-mintz

https://www.reuters.com/markets/us/stablecoins-face-bank-like-us-regulation-under-draft-house-bill-source-2022-07-20/

https://humaninterest.com/learn/articles/secure-act-2-understanding-proposed-legislation-securing-a-strong-retirement-act/

https://www.jdsupra.com/legalnews/naic-insurance-data-security-model-law-1854646/

https://www.forbes.com/advisor/retirement/secure-act-2/

https://www.theguardian.com/technology/2022/jul/14/ransomware-attacks-cybersecurity-targeting-us-hospitals#:~:text=The%20number%20of%20ransomware%20attacks%20on%20healthcare%20organizations%20increased%2094,up%20from%2034%25%20in%202020.

https://content.naic.org/cipr-topics/cybersecurity

https://www.businessinsurance.com/article/20220309/NEWS06/912348424/Captives-can-play-key-role-in-ESG-initiatives

https://www.gartner.com/doc/reprints?id=1-29FBE5ZT&ct=220317&st=sb

https://www.whitehouse.gov/briefing-room/presidential-actions/2021/05/12/executive-order-on-improving-the-nations-cybersecurity/

https://content.naic.org/sites/default/files/inline-files/MDL-668.pdf

https://advisory.kpmg.us/articles/2021/ten-key-financial-services-regulatory-challenges-2022.html

https://gdpr-info.eu/issues/privacy-by-design/#:~:text=The%20term%20%E2%80%9CPrivacy%20by%20Design,in%20the%20technology%20when%20created.