CAPTIVE OUTLOOK POST PANDEMIC

Written by Karrie Hyatt

While the economic issues surrounding COVID-19 are widespread and still evolving, companies are facing both financial and operational impacts. For captives, this crisis highlights their value. This high-risk, low-frequency situation is what many captives were created for. Right now, captives are showing how valuable they are.

The flexibility that captives are known for is allowing them to help their owners in ways that companies with traditional insurance cannot. Captives are helping their owners bridge financial uncertainty by using their surplus capital as intercompany loans or as dividends to owners, helping them to address cashflow demands during state mandated shutdowns. Captives are making changes to policies to plug gaps in coverage.

Regulators are helping both owners and captives too. In Vermont, regulators are allowing policy coverages to continue at no charge or at reduce premiums for captive owners that have been hit hard during the crisis.

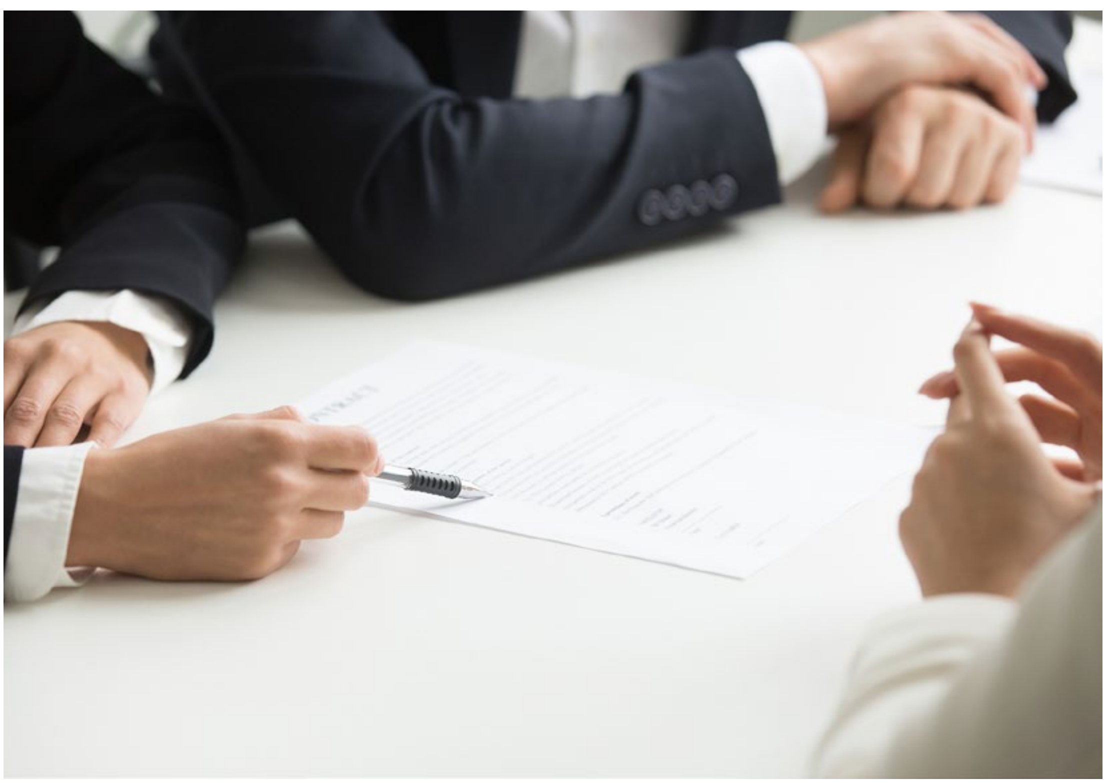
According to Sandy Bigglestone, director of Captive Insurance with the Vermont Department of Financial Regulation, “We plan to continue to work with captive owners to help them accomplish their goals as they manage the crisis. With a degree of variability and future unknowns, we need to prioritize with a sense of reality and regulate with a balanced approach. We do not see the value in holding onto excess surplus in captive insurance companies when it can be used to ease the stressed environments captive owners are already experiencing.”

The future for most businesses is uncertain right now, but for captives, the future looks bright.

OUTLOOK FOR CAPTIVES IS POSITIVE

Coming into 2020, captives were poised to have a successful year and while the pandemic has considerably changed the market, captives are positioned to not only to rise to the challenge, but to grow in a contracting marketplace.

Michael A. Corbett, senior vice president with Pinnacle Financial Partners and former Tennessee captive regulator, “Since the end of last year, I’ve heard talk about renewals [in the traditional market] that are increasing by 50, 75, 100 percent. Businesses facing those kinds of premium increases are saying, ‘I’ve got to do something different.’ Captives are going to be a great solution to a lot of players.”



“We had an approaching hard insurance market before this pandemic put a stop to everything so if we can get back to the economy we had before the shut down in relatively short order, I believe captives will increase in formation simply due to the hard market,” said Jeffrey Kenneson , president, Davies Captive Management.

“As far as the pandemic, I think it will affect captives like 9/11 did where there will be some formations due to the event but more likely existing captives will expand coverages to address the shortfalls they’ve identified in their coverages during this shutdown phase.”

The traditional insurance market is being hit hard by the COVID-19 crisis. Capacity will be further tightening which will leave many businesses without key coverages. Again, this is where captives hold their own and will likely see an increase in new captives and new lines added to existing captives. Corbett expects to see established captives expanding their coverages to cover pandemics, business interruption, or loss of employees. “There’s going to be a lot of amendments to existing plans over the next year.”

Bigglestone said that Vermont is still seeing new applications coming in at this time. "The hard market had cycled in before the pandemic, and I do not anticipate it will change post-pandemic as commercial carriers try to make up for their operational and financial impacts. The commercial market may fall short with providing the needed capacity or specific coverage needs of businesses, so captive insurance will continue to thrive."

ISSUES CAPTIVES ARE FACING

While the overall outlook for captives is positive, there are a number of issues that captives of all sizes will face. Some of the issues are those that are affecting the financial sector as a whole and some are exclusive to captives.

As captive owners see large business losses or are forced to close their doors, captives will be likewise shut down. According to Kenneson, "If we see a major downturn in the economy once we're technically back in business, whatever that's going to look like, and the economy ends up being in recession or worse, some of these businesses that are thinking about captives may not need them due to the retraction in their businesses."

For Biggleston, "If the captive owners' business does not survive, the captive will not survive either. We anticipate there will be a serious impact. We have only had one (newly approved) protected cell close due to the owner's financial distress caused by the pandemic on its business."

As the traditional market will likely be contracting steeply and increasing premiums exponentially, it will become harder for captives to secure fronting arrangements, and perhaps even reinsurance. "You can get somebody to take the upper layers a lot easier than the lower layers. Lower layers are the ones that cost the most," said Corbett.

According to Bigglestone, "When you consider the lines of insurance coverage in captives, combined with the nature of the owners' operations, you can begin to make preliminary assumptions about business continuity. The Vermont DFR formed a COVID-19 task force within the captive insurance division to gather information. One of the tasks we are focused on is assessing risks by industry sector to better understand the potential impacts to our companies. So far, we are seeing direct impacts on the captive owners, but only indirect or minimal impact on the captives."

Many segments of the captive marketplace will be impacted by the pandemic—transportation, hospitality, retail, entertainment, and the energy and oil industries. These sectors have seen a steep reduction in business due to COVID-19 pressures and the shutdown of business operations. While the businesses themselves in these sectors are experiencing a retraction of income, their insurance exposures are much reduced which could be reflected in their next round of premiums.

Then there is the Healthcare industry. Exposures in general liability, professional liability, workers compensation, medical stop loss—all of these lines will be very stressed, and there will be a knock-on effect from the traditional sector that will be felt even by captives. Some of this exposure may be reduced by actions through states that may provide immunity related to COVID-19.

"We are mindful that COVID-19 may create a broad professional liability crisis across the healthcare industry," said Bigglestone. "There are so many factors to consider and all kinds of possibilities that remain to be seen. We may see more closures, so preparing for what is to come. In the meantime, we are watching closely and working diligently on keeping abreast of COVID-19 issues as the crisis evolves."

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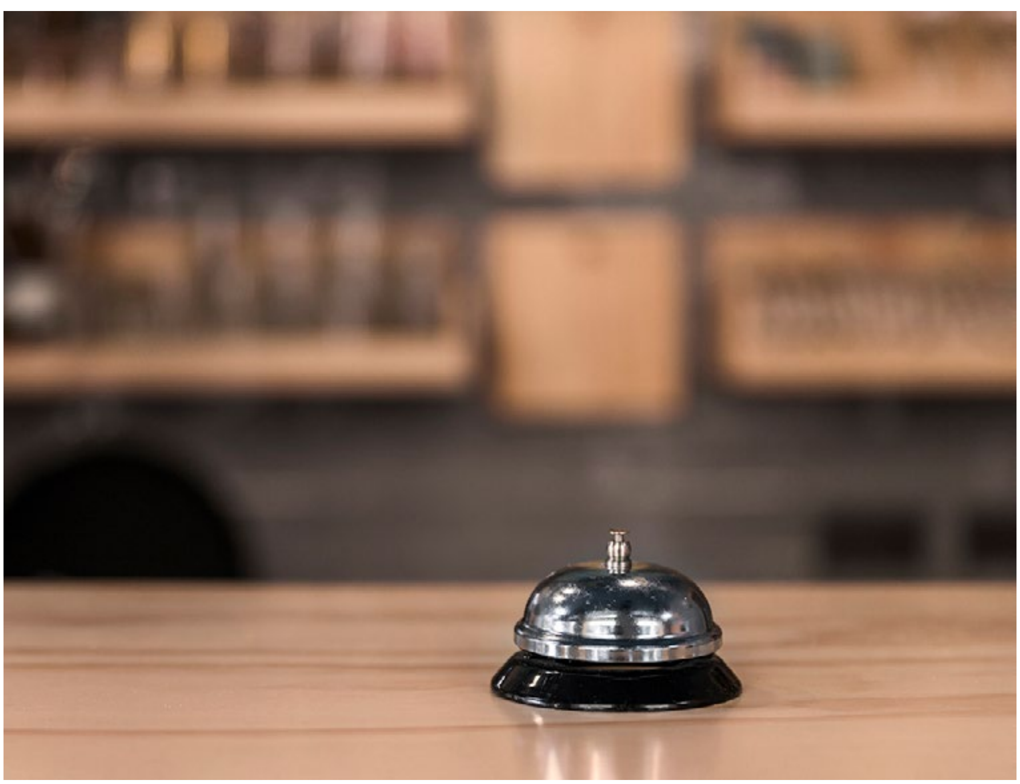
EMERGING COVERAGES

One of the most thought-provoking issues to come out of the COVID-19 crisis are the revelatory gaps in coverage along many lines of insurance, particularly business interruption. Not only holes in coverage, but also coverages that are not being triggered by the crisis the world is currently facing.

According to Kenneson, "I think owners of non-micro captives are finding holes in their coverages especially when it comes to business interruption. For owners in the hotel, retail, tourism and other businesses that rely on the free flow of consumers throughout the economy, this shut down and sudden stop to commerce has given them a reason to look at their insurance policies. In that process, they are finding that their business interruption policies are only triggered when there is some other covered event that occurs."



Pandemic liability coverage is the most obvious new product to come out of the current situation, yet it will not be easy to insure. Lack of actuarial data is going to make this a very hard to insure risk. "Pandemic cover is not going to be an off the shelf item at some of the main traditional carriers. It's going to be something that you have to get from companies like Lloyd's," said Corbett. "I am particularly interested in the idea that PRIA [Pandemic Risk Insurance Act] may see the light of day to help companies manage risks that may have become too big for the reinsurance industry."

Most businesses will probably not seek pandemic coverage but will look to expand their business interruption coverage. "Enhancements to business interruption coverage is one way that COVID-19 might find its way into an organization's risk management program," said Bigglestone. "The typical contingent business interruption policy will not likely cover a shutdown or slowdown of business due to a global pandemic. Event cancelation coverage and possibly stand-alone pandemic coverage are other options. Captives are ideal vehicles for businesses to fund these risks."

Lines of coverage that would fall under business interruption are things like payroll protection or loss of employee insurance. Corbett said, "What everyone is facing today is a business not losing employees because they quit [or they had to let them go], it's because they couldn't afford to pay them anymore." Payroll protection liability would allow for businesses to keep their employees during temporary shutdowns.

From a business travel perspective, both individuals and companies have found during the shut-down that standard travel insurance does not account for pandemic and 'no travel' government notices and have resulted in losses for cancelling trips.

According to Corbett, "The travel insurance industry is not going to redo their policies to include pandemic. That's a great opportunity for captives to expand their coverages. If the insurance isn't going to cover all cases, then companies may be able to put corporate travel insurance into their captive."

Lining up with incorporating travel insurance into a captive would be adding event cancellation coverage. Events have been cancelled on every level—from board meetings to multi-day music festivals—which means millions of dollars lost. Event cancellation coverage, which is a common coverage for large events, will become more common for events of all sizes—utilized by both hosts and attendees.

Employee benefits risk has been a fast-growing addition to captive insurance during the last decade, and industry professionals believe that the COVID-19 crisis will only accelerate this trend. The employee benefits liability sector is being strained over the pandemic as many businesses are seeing multiple concurrent incidents of insureds being hospitalized. Employers without this insurance will be sure to be adding it and businesses that already have the coverage will be looking to increase its coverage.

For now, the COVID-19 pandemic is still evolving and how it will ultimately affect the financial and operational impacts on captives is still a long way off, but the captive sector is poised to take these changes and thrive. Bigglestone said,

"The insurance market is in turmoil; having a captive insurance company brings a certain level of order and a degree of certainty to a chaotic environment. Mid or post-crisis, a captive insurance company is a risk management and financial tool that can represent a bright spot in an organization." ■

Karrie Hyatt is a freelance writer who has been involved in the captive industry for more than ten years. More information about her work can be found at: www.karriehyatt.com.