FEATURE

Looking Ahead to the 2023 Captive Industry

Written By Caroline McDonald

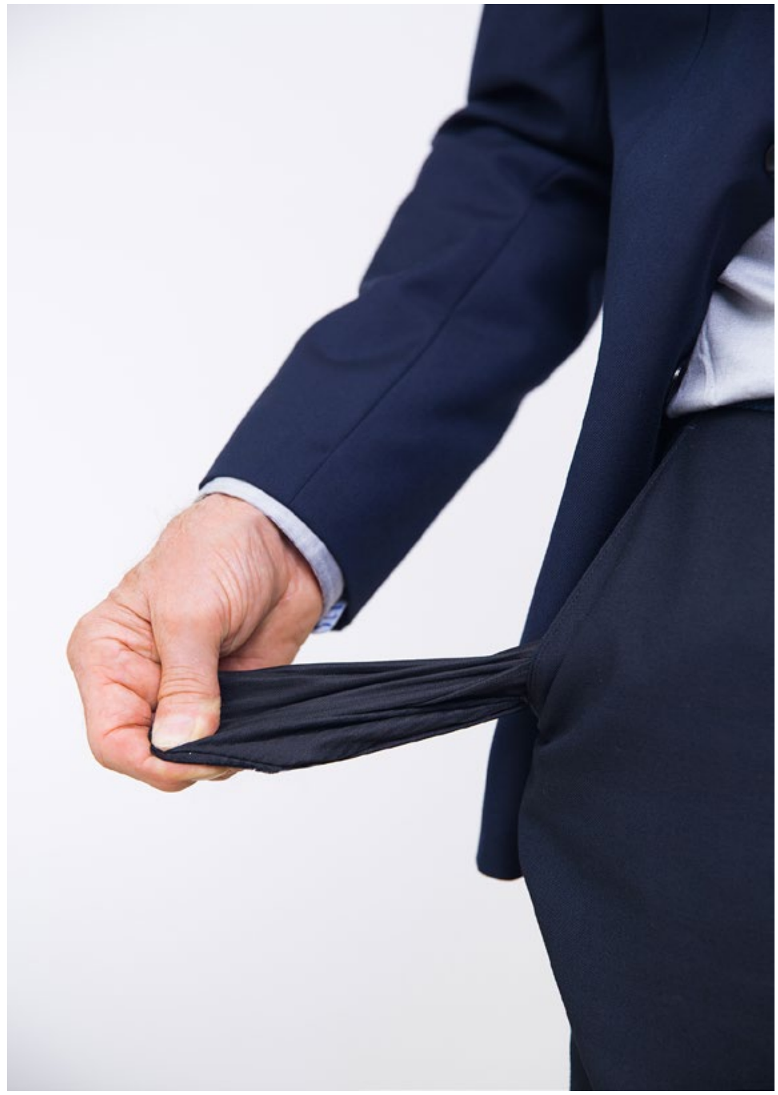
What is in store for captives in the year ahead? It depends. What industry are you working in? How is the captive used? Where is it domiciled and what size is it? And there are two other important variables: the stability of the financial system in the United States and the IRS's interest in captives.

"I do a lot on the small captive side with 831(b) captives, and we continue to see a lot of IRS audits and activity around them," said Bailey Roese, partner at Dentons Bingham Greenebaum LLP.

"There are some cases pending in the tax court, so we will probably see movement on a few of those," she said. "The IRS is focused on litigating and not afraid to take those through the courts. We'll be busy with audits and litigation through the tax and appeals courts."

Then there's taxation. Roese noted that there is an increased focus among the states on the taxation and treatment of captives. "If we go into a recession, we'll be looking for states to look at ways they can generate more revenue," she said.

The possibility for tougher economic times, including inflation, also have potential advantages for the captive industry. It gives a business the ability to write its own coverage, "and be sure it won't be in for a rough surprise because of the cost of the policy, or a claim's been denied because they don't have as much coverage as they thought," Roese said, adding, "Companies want the ability to control what they can and to be in the insurance business."



Jeff Fitzgerald, vice president of employee benefits at Innovative Captive Strategies, who oversees many of their employee benefits programs, and is a long-time member of the SIIA captive committee, added that captives have continued to grow and that premium for group employee benefits captives is also on the rise.

Tony Minnich, vice president, captives at Tokio Marine HCC – Stop Loss Group confirmed this, noting, "While it is difficult for us to speculate premium and percentage of premium for other carriers, I can confirm that stop loss premium in the TMHCC stop loss captive is around 25 percent of our overall premium, and growing."

Fitzgerald observed that the growth of enterprise risk captives continues to fluctuate, "depending on the vagaries of the IRS."

For enterprise risk captives writing business-related insurance risks, in U.S. based domiciles, *"The IRS at times is less interested in them and at times more so,"* he said. *"The vast majority of these are very well run, addressing a specific problem of an individual employer or company."*

Nevertheless, there is also the issue that "the IRS has decided they don't like them regardless of the fact pattern. Unfortunately, you can always find a bad apple among them." And that, he noted, can tar the entire industry.

What can help this situation is a captive manager code of conduct, "which SIIA worked for years to come up with." He added, "We believe, as SIIA members and captive manager consultants, that there are certain norms that need to be followed. And a lot of it is that they are not."

Captive managers must observe high standards of ethical conduct to properly serve their clients and to increase the captive industry's role as a premier risk management and financing tool.

IMPACT OF COVID-19

The reality with employee benefit captive programs is that COVID-19, from an individual claimant perspective, "was not as bad a people initially thought it would be," Fitzgerald said. "This doesn't address what people had to put up with in their daily lives, but the actual claim, itself." He added that procedures for COVID were not as expensive on an individual basis as it was believed they would be.

As a result, captives performed moderately well, because claims weren't as high as anticipated, "and there was a delay of care that is just now getting through the system." At the height of COVID, when people weren't going to the doctor, "a lot of things got pushed out," Fitzgerald said. "With some elective procedures, the question is, did they ever get done? Did someone decide they didn't need to be done? These are now being caught up with."

During the pandemic, people were also working at home, "And there was an interesting piece, where payroll for a lot of companies went down because people were being laid off," he said.

Some other sectors had the opposite situation. "I am familiar with groups that were using enterprise risk captives," he said. "Those are for balance sheet risks related to cash flow or supply chain." Some companies had claims they would not normally have had and having an enterprise captive to capture a balance sheet risk helped, he said.

For example, losses from a supply chain risk can't be insured, but a company still may obligations to meet, Fitzgerald said. With an enterprise risk captive, a company was able to make a claim, "because they still had to pay bills and their employees, but maybe they weren't able to get product in to sell."

The fact that captives were allowed to do this was "a release valve for a company that would not have had it otherwise," he said.

CAPTIVES FOR FLOOD COVERAGE

Captives have also proven to be advantageous for businesses in flood-prone areas. "One that I am currently forming in Vermont is a south Florida-based, roughly 9,000-unit residential habitational real estate company that has gone bare on their named windstorm," said Dave Guerino, senior vice president and managing director at KeyState Companies, captive management. "They have decided to fund for that in their captive as well as other risks."

Another example, he said, is a community bank in the northeast. "Post-Hurricane Sandy, they were forced to take a per-branch retention of $250,000, so they said this was the perfect time to use their captive."

Post-Ian, he said, "I would expect to see some additional capacity or sublimits applied to the insurance programs that are in place."

LOOKING AHEAD

While formations had been down for a period, "Lately we've gained a lot of momentum. In 2022, It really kicked in," Guerino said. "We're hearing that Vermont is going gangbusters in their formations and will have one of their biggest years in a long time."

One reason is the market, which has caused some organizations to see 100-200 percent increases on cyber and P&C coverage, he said. There have also been sublimits and capacity issues to deal with. "So, from the community bank captive program, there has been a lot of interest in captive formation, because those were the primary drivers," Guerino said.

The hard market may be easing, however. In a discussion with a large global financial institution about their cyber insurance, Guerino was told that they were expecting 15 to 25 percent increases on their Jan. 1 renewals, "but they said it now looks like it will be 7.5 to 10 percent."

The company had been looking at adding a layer in their captive, “but they don’t think they will have to do that now,” he said.

Looking ahead, Guerino believes that formations will remain strong for the first half of 2023,“ because people have felt the pain of their insurance market and the pandemic,” he said. “We will continue to see activity, but if the market starts to plateau or soften, that will slow down captive formations.”

Roese noted that conversations regarding captive formations that she had with regulators at the SIIA conference in October, indicate a “definite upward swing,” she said. “Some of the 831(b)s have slowed down, but other captives are being formed regularly and there is still big interest in forming them.”

According to Roese, more of the formations are for traditional purposes, with the main one being control over insurance policies. “People want to be able to oversee the claims process and not have to go through a commercial provider for that,” she said.

So, what lies ahead in 2023? Clearly, captives remain an attractive alternative for many types of businesses. And in numerous cases, they are growing in use and application. The economic health of the United States in 2023, however, is still an open question, and COVID-19 dangers remain. Also, IRS involvement and aggressiveness is a factor. Then there is the weather, inflation and the Federal Reserve.

In a volatile economic climate, it is difficult to make a blanket analysis. But overall, the captive industry has weathered the COVID-19 crisis better than expected. And it is poised for significant growth in 2023. ■

Caroline McDonald is an award-winning journalist who has reported on a wide variety of insurance topics. Her beat has included in-depth coverage of risk management and captives.