Bloomberg Reports Increased Use of Captive Insurance

An article from Bloomberg.com (https://bit.ly/4dS6f2z) is a rare instance of mainstream reporting on the arcane world of captive insurance. Bloomberg also calls it "in-house insurance" while a climate activist calls it "shadow insurance". Whatever you call it, Bloomberg's article noted an Aon report on an "uptick" in use of captive insurers and an overall increase in companies reporting use of captive insurers from 17% in 2021 to 25% in 2023. Premiums for Aon's managed captives have also risen. Bloomberg reported on how captive insurance premiums have "boomed" to $200 Billion. It also focused on how climate change was leading to more natural disasters, and on the move by some insurers away from insuring the fossil fuel industry. Both trends led to fewer coverage options and higher premiums and an increasing need for captives.

From my own perspective, the increase in captive insurance has been steady for as long as I have been involved with this area of the property and casualty insurance business. In the 1970s the Three Mile Island nuclear meltdown led to the formation of a group owned utility captive to write property damage, business interruption and extra expense for nuclear power plants (Nuclear Electric Insurance Ltd.). I began my legal career counseling NEIL. This group captive was large enough to be self-managed and eventually they moved to Delaware under their captive law (which I believe is limited to those who have an actual office and employees in the state). Enveron (f/k/a Oil Insurance Ltd.) was another group owned captive for the oil and gas industry also founded in the 1970s after some spectacular losses. I believe that now, as in the past, increases in insurance premiums and/or reductions in available coverage usually lead to spikes in formation and/or use of captive insurance companies. Those same trends are also leading to increased use of insurance linked securities by insurance companies and reinsurers.

Many Fortune 1000 companies, large professional service firms, large health systems and educational institutions and other risks have formed their own captive reinsurers, whether singly or as part of a group of similar insureds. The benefits include direct access to reinsurers, cost savings in the "working layer" of losses,

more control over claims handling with unbundled third party claims administrators etc. However, these captives cannot write workers compensation (”WC”) or commercial automobile (“Auto”) under US law so they turn to licensed carriers to write their risk then cede some primary layer (generally $250,000 to $1 million per occurrence) back to a captive reinsurer owned by the insured. Because general liability is also written with the WC and Auto, all three coverages (a/k/a (“primary casualty”) are generally ceded to the captive. This arrangement, which is sometimes called “fronting” has its own set of regulatory issues. The captives are either licensed in a single state or domiciled and licensed overseas. They are also much more thinly capitalized under their captive enabling legislation so that the licensed US carrier will require collateral that meets state credit for reinsurance requirements. The collateral is usually in the form of letters of credit but can also be posted via a compliant reinsurance trust agreement or funds withheld. The reinsurance agreement between the licensed carrier and captive reinsurer must address the issues of ceded limits, coverages, costs, accounting and reporting, claims handling and standard contract conditions for reinsurance. In addition, since the captive reinsurer is unlicensed and/or too thinly capitalized for purposes of credit for reinsurance, the type, amount and adjustment of such collateral must be addressed in the agreement. NY regulations are the standard for compliance and most states follow NY or the NAIC model law for credit for reinsurance. The insurer must also have the means to accurately analyze its loss exposure in the captive ceded layer and to set collateral requirements sufficient to pay for estimated losses including any adverse loss development.

Certain lines of business such as malpractice liability insurance, property insurance and general liability insurance do not require a licensed carrier strictly speaking so could be written directly by the captive insurer. In some cases, they are. However, there are regulatory issues, especially around Federal Excise Tax for offshore insurance cessions, surplus lines compliance and taxes for US domiciled captives or the state tax on directly procured insurance. Claim adjustment and payments in the US or across state lines may also raise regulatory issues so insureds and their captives often choose to have these coverages fronted as well.

Harris Insurance Law has long experience with the contracts, the structures and regulations for both single owned and group owned captive insurance companies.

We stand ready to provide advice and service in this area and other areas of property and casualty insurance law.

September, 2024