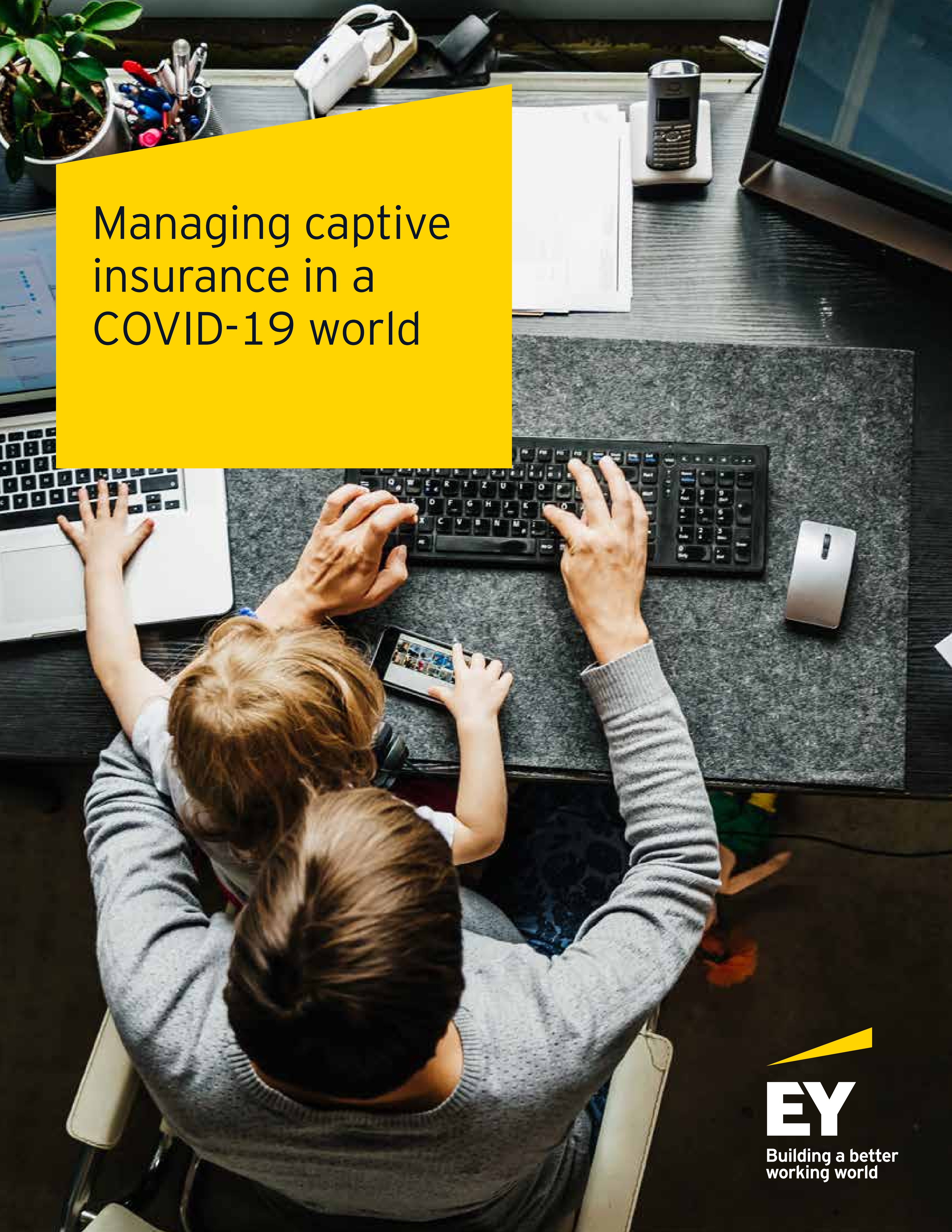
Managing captive insurance in a COVID-19 world



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Abstract

This text will provide an overview of the impact of COVID-19 on major lines of insurance, its impact on social inflation, and how companies and their captive insurance entities can adjust to those times.

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Overview

The captive insurance industry has experienced a drastic change from its steady state during the last year due to the COVID–19 pandemic. The effects of COVID-19 can be seen in a few different ways. The most apparent change relates to the surge of inquiries on whether insurance coverages cover losses that are directly or indirectly caused by COVID-19.

In the insurance industry, the major lines of business impacted by this pandemic are displayed in the below chart:

Lines of business impacted by COVID-19

Commercial property	Claims alleging direct physical loss, business income losses resulting from civil authority orders, and lost profits due to customer or supplier interruptions
Workers' compensation	Claims alleging exposure to COVID-19 at work, with disputes as to whether claims are sufficiently tied to claimants' work; potential regulatory changes in the definition of workers' compensation
General liability	Negligence, products liability, personal injury and exposure claims by claimants allegedly contracting COVID-19 while on a business's premises or because of a company's actions or inactions
Medical malpractice	Breach of duty related to rationing of care and/or lack of qualifications to provide care
Directors and officers insurance	Disclosure-related claims or claims relating to alleged mismanagement related to COVID-19
Errors and omissions insurance	Medical professionals failing to properly address exposure; acts, errors, misstatements or omissions by insurance agents or brokers related to coverage for COVID-19
Event cancellation	Various sports, trade, entertainment, music organizations, as well as individuals, seeking recovery for canceled events
Pollution liability	Claims alleging that the term "pollutant" includes COVID-19 disinfection and decontamination expenses
Employee Retirement Income Security Act (ERISA)	Short- and long-term disability coverage can be triggered due to a diagnosis related to COVID-19
Trade credit	Disruption in sales leading to inadequate cash flow to cover agreed-upon payment terms
Mortgage insurance	Increase in missing payments and default on mortgage payments

US gross domestic product fell at a record 33% annualized rate in the first quarter of 2020, according to information from the Commerce Department on July 30, 2020.

In the following sections, we will look in detail through many of these lines of business and assess the impact of COVID-19, while linking those changes to the impacts on the captive insurance industry.

Commercial insurance

Captive insurance is often structured to include risks excluded by the commercial insurance market. Commercial property policies typically include pandemic exclusions that remove business interruption coverage. However, it is particularly germane to review the property coverages to determine whether the captive insurance company includes those pandemic coverages, which are typically excluded by the insurance industry.

Captives can also cover low-frequency, high-severity events, such as a pandemic, as a line of insurance itself. In the author's experience, pandemic coverages are invoked in captive contracts and particularly utilized in 831(b) micro-captives. An instance in which a captive has implemented pandemic coverage, but experiences no losses associated with COVID-19, would raise serious questions. Regulators would question what the pandemic insurance risk could be if not triggered by COVID-19, given the severity of the occurrence and the unlikelihood of being completely unaffected by this event.

In instances where direct pandemic coverage is provided, it is typical insurance practice to determine the likelihood of a loss and the potential loss amount associated with each potential claimant/insured. For contingent business interruption losses, this can be done through financial projections associated with the economic impact of COVID-19. Event cancellation losses are usually determined by taking an event-by-event approach for each instance and developing associated time frames as to how far loss events might extend into the future.

Workers' compensation

Workers' compensation insurance typically does not cover the everyday common illnesses but covers work-related illnesses. In response to the COVID-19 pandemic, many states have enacted presumption rules that would make the instance of catching the virus at work covered under workers' compensation law. The COVID-19 losses associated with workers' compensation may be particularly relevant to first responders and critical workers who maintained their operations in the workplace. Even if they were wearing protective gear, many health care workers had a higher and consistent exposure to the virus since they came in contact with the general public and coworkers in the course of their work.

Medical malpractice

Medical malpractice insurance is another area that could bring rise to future claims activity driven by COVID-19. In many parts of the country, the health care system has been overwhelmed with COVID-19 cases. The stress on the health care system resulted in situations where patients were refused or provided with only limited care. Alternative care such as telemedicine saw a surge during this period due to the desire to maintain social distancing, combined with the limitations and restrictions in place to limit direct physical contact. Therefore, medical care practice was sometimes suboptimal, which could result in an increase to medical malpractice claims. It will be interesting to see how liability is determined in these instances, as frontline medical providers were generally perceived favorably during the pandemic by providing care during very difficult circumstances. Insurance industry experts are monitoring the situation as the positive perception of health care workers during the pandemic has been deemed by some to potentially have similar impact as prior tort reform efforts.

Other types of insurance

Trade credit and mortgage insurance are also monitored on an event-by-event basis, similar to event cancellation with the additional element of having a loss ratio projection based on crisis scenarios. These scenarios vary with the uncertainty associated with grace periods and the potential workarounds for loan repayment or refinancing that may or may not be put into effect.

The COVID-19 pandemic will also affect lines of insurance that have no direct coverage implications. A major way in which coverage can be impacted is through changes in exposure. These changes include both the magnitude of exposure as well as exposure activities. For example, workers' compensation is typically based on payroll, and many companies have lower payrolls based on a reduction in employees as well as in hours employees may be working. Similarly, many workers have been working at home as opposed to working at an office site and traveling for business activities, which changes the activities conducted during work.

Many insurance coverages use various exposure bases to determine the insurance coverage and associated premiums, such as payroll, sales, miles driven and square footage. Some of these exposures are highly sensitive to economic activity. COVID-19 has generally resulted in a severe economic downturn, with real GDP decreasing approximately 33% on an annualized rate in the second quarter of 2020, and Treasury rates nearing 0% as of July 31, 2020, with no expectations of quick recovery. The impact of the economic downtown, coupled with the change in work activities, will have a major impact on exposure and its associated loss propensity.

Therefore, insurance captive premiums may be subject to audit based on their actual exposure information. Captive managers and management personnel should be aware of potential premium swings based on the impact of auditable premium exposure bases. Many insurance premiums will decrease by large amounts if the premium is auditable and no cap on the adjustment is specified. Premium may also decrease for premiums that are not subject to audit. Many auto insurers have provided rebates to customers for the reduction in miles driven, since insureds don't have to commute to work, and many benefits providers have provided rebates to customers for coverages such as dental insurance, which provided less coverage due to closures, restrictions and fear from the general public. It will be very important for captive personnel to stay on top of the impact of premium fluctuations based on the movement in exposure levels.

Changes in exposure driven by COVID-19 are just as relevant for captive insurance operations. Many employees are working from home; many automobiles are being driven less, and on less crowded roads. Every industry and insurance portfolio will have a pronounced change in activity based on the adjustments brought on by living in a social distancing world. For most insurance coverages, the COVID-19 impact will be a decrease in loss propensity. However, for some exposures, there may be an increase in occurrence and variability. It is important for captive insurance operations to try to understand the change in underlying activity associated with insured operations. It is not enough to maintain analytical and actuarial processes from the past without conducting a survey on the impacts or compiling a list of necessary changes in operations. Furthermore, decreases in exposure base may not lead to proportional decreases in losses, as the response to COVID-19 may affect the nature of the exposure base. For example, there have been reports of higher incurred claim severity, likely due to more speeding, given the lower volume of traffic on roads. A mile driven may not lead to the same average dollar loss experienced before the pandemic as during the pandemic shutdown.

Social inflation impact on captives

Over the last few years, social inflation has become a major consideration for the main casualty lines of coverage. While social inflation has no precise definition, it generally refers to higher insurance liability claims, particularly for larger-valued claims, due to the following (non-exhaustive) phenomena:

- Increased propensity for claim litigation
- Broad interpretation of insurance coverage
- Plaintiff-friendly legal decisions
- Increasing severity value of claim settlements and jury awards

The insurance industry has seen up to a 100% increase in settlement values for some classes of large claims over the last five years. However, the social inflation impact on insurance will change as we adjust to the new COVID-19 environment. In the first few months of COVID-19, many courts closed, resulting in a decrease in both economic activity as well as claims activity, which leads to the perception of a short-term decrease in social inflation. There have also been instances of more favorable claim settlements based on the need for cash in an uncertain environment. Therefore, there is greater uncertainty regarding the impact of social inflation and whether recent increases in social inflation will continue when the economy resumes enhanced levels of activity.

Along the same lines, captive insurance operations will have a great deal of uncertainty associated with activities until there is a level of economic stability. It is important for captive operations to closely monitor both their premium and loss projections to help navigate operations successfully. It is also important for captive owners to be aware of potential new program opportunities.

Conclusion

In the following months and years, capital may be limited for many companies that purchase insurance due to the economic constraints and lack of revenue. However, the federal government is helping companies and individuals, notably with the CARES Act, which has put in place incentives for companies that suffer economic losses to offset against past income taxes paid. Overall, the current commercial insurance marketplace is generally experiencing increases in rates and limitation of available insurance capacity for some coverages. Insurance coverages impacted by COVID-19 are experiencing even larger premium increases and have even less capacity than before. Therefore, captive insurance companies and the potential expansion of captive insurance operations may be the most helpful way to help organizations to efficiently manage risk in a cost-effective manner in challenging economic times.

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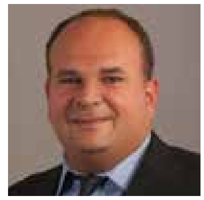

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