

Captive Runoff, History, Outlook, and Perspective

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For-profit insurers and reinsurers have occasionally needed to back away from a niche in which they have not been successful. Over the years, there have been failures of insurers and reinsurers which inevitably result in run-off, whether called liquidation, receivership, a “scheme of arrangement,” or some other label. Somewhat less disastrous than a failure is the fire sale, in which new capital is provided to bear risk in the company, at the expense of the previous owners, who lose some or all of their ownership interest. (Think of AIG shareholders’ capital being replaced by new capital from the U. S. Treasury, or think of Bear Stearns’ shareholders’ capital being replaced by new capital from JP Morgan Chase, plus certain guarantees from the Treasury.)

Single-parent captives and group captives have their own distinct reasons for going into runoff. Over the course of several underwriting cycles, certain single-parent captives discovered losses suffered from competing in the assumed reinsurance business were far greater than the tax benefits expected from writing unrelated business, and their parents decided to support their captives through a long and expensive runoff, often to protect the reputation of the parent via honorable satisfaction of the obligations of its subsidiary. During recent soft markets, several group captives (among others, certain RRG’s) lost members to commercial insurers and decided to cease underwriting operations, and go into runoff. Also, in recent soft markets, single-parent captives already licensed and capitalized, have sometimes been left un-used by their parents, and are de facto in runoff. Further, following a number of mergers at the parent level, the number of single-parent captives left in run-off by their newly-merged parents has added to the total number of runoffs in the captive sector. At least one captive has been moved and then placed in runoff by its parent taking advantage of favorable law and precedent, leading to some controversy over the propriety of the move.

In 2002, Rhode Island enacted public law 381, allowing solvent insurers to restructure (and to redomicile to that state) for the purpose of runoff. As of 2009 to date no insurers have moved under this law; reasons suggested for the lack of action include uncertainty about how regulation will develop around the new law, uncertainty about how courts will treat claims involving a redomesticated insurer, or possibly concern that controversy over another redomestication and runoff could create reputational risk.

In a state where captive regulation is mature, with a robust community of captive managers and other professionals, no such legislation is required. Captives already redomesticate among captive domiciles. Captive managers already manage a number of captives in runoff with somewhat less effort than required for management of a captive still writing business. Group captives already have been licensed for numerous exotic coverages, and reinsurance of a runoff book has already been written by numerous reinsurers. All that is required to support a domestic runoff operation is capital, expertise, and the strategic decision to provide a market for captive runoff business. Such a market can be risk-bearing or administrative:

1. A risk-bearing captive runoff company might look like a group captive, with the group members being either the group of captives in runoff or the group of parents of those captives. In either case, the manager of the group captive has the same tools as the manager of a more traditional company in runoff, but the underwriting decision made by the manager of the group runoff is how much capital to require from each new member of the group. The alternative to member-ownership is to abandon the captive license status, and to attempt to be licensed as a more traditional for-profit insurer or reinsurer. Yet another alternative is for a runoff company to buy an existing captive. This may be more difficult in certain domiciles than in others, but the UK firm of Randall & Quilter has already bought at least one captive and one captive manager (in two different domiciles.)
2. An administrative services captive runoff company could look like a traditional captive manager, providing staff to support only the accounting and operational support offered to the typical single-parent captive. The capital at risk remains as it was under the prior administration, and the only risk born by the captive manager is the reputational risk of managing a captive at the time statutory surplus becomes deficient. An established captive management company can keep its market share by offering runoff services for individual captives at a reduced fee, considering that it is not going to be providing services related to new and renewal policies and premiums.

If a captive domicile, with a robust community offering support services for captives and a mature regulatory team were to consider legislation like Rhode Island's PL 381, an immediate concern would be how to fund the regulatory operations without the premium tax produced by so many on-going captives and other insurers. The Rhode Island approach spelled out in PL 381 includes fees for each runoff company somewhat larger than the fees charged to insurers that are going concerns, and a similar approach could be used to fund the continued robust regulatory resources of the domicile. Regulators already have the discretion to approve only new insurers with enough capital for the risks proposed in the license application, and the capital required for a given runoff would be a logical starting point for the licensing decision.