THE INSURANCE ACT AND CAPTIVES

Tom Miskin of Mactavish takes a close look at the Insurance Act 2015

It is now over three years since the Insurance Act 2015 (the Act) came into effect. Many – perhaps the majority – of captive owners have not yet taken some of the changes into account. There are of course many reasons for this delay, but perhaps chief among them is the complexity of the impact of alterations to governance and reporting.

While much of the debate at the time of the Act focused on the obligations of insurers and insureds, captive owners find themselves in the unique position of acting as both. And when captives access reinsurance facilities they introduce a complication that can make the compliance burden that much heavier.

We would encourage captive owners to look again at the Act for two reasons. The first is rather obvious as failure to comply can land them in hot water – not only are they in breach of the Act, but they could face difficult questions from the fiscal authorities about the validity of their status as a captive.

The second reason is more positive, put simply, enacting the reforms required by the Act can make a captive more efficient – as both an underwriter and a marketer of risk.

Among all of the noise around the introduction of the Act, one important principle was often forgotten: the overriding intent of the legislation was to professionalise risk placement. The reforms required to comply with that principle and the specific requirements that fall under it are manifold, but there are two clear areas of focus.

The first falls under the duty of disclosure. Here, the crucial element is the new principle of 'fair presentation' which attempts to clarify exactly what a policyholder is obliged to disclose to its insurer and to introduce a graduated system of withdrawal of coverage should the insured breach its obligations. The Act also introduces expectations on insurers to engage professionally with submission materials, ask questions, and consider information already available.

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The second important area is warranties and other onerous conditions. Here, the burden falls more heavily on the insurer, who will no longer be able to withdraw coverage automatically should the insured be in breach of a warranty or other onerous term.

What does this mean for captive owners?

As an insurer, a captive needs to consider the impact of the Act on their underwriting and claims handling. The Act places much greater emphasis on how an insurer should review a submission. Captives that do not assess the information available, maintain underwriting records, and ask follow-up questions could be undermining their rights in respect of fair presentation, and therefore leave themselves open to allegations that they are not acting independently.

Similarly, wording issues such as contracting out of the Act need to be considered during renewal and during claims – the same as external market insurers are.

However, the most obvious – and difficult – impact of the changes is knowledge management, especially when the captive assumes the duties of an insured buying reinsurance.

Unlike a third-party insurer, more often than not, the leadership team of a captive will have a very good working understanding of the company that owns them. In some cases, they may share board members, or recruit executives from the parent organisation.

The Act clearly states that fair presentation requires the disclosure of information that is known to its 'senior management' or those directly tasked with the management of its insurance. That may be information that they already hold, or that can be found following a 'reasonable search'. For captive managers it is likely that they will know a lot more than if they were writing the risk at a commercial insurer. The captive managers might also have unique knowledge that isn't in the submission, but could be relevant to reinsurers.

This creates complications when the captive is seeking reinsurance. Put simply, where are the lines drawn between what the insured knows, what the captive knows and what the reinsurer is given? Often captives are effectively bypassed, with the submission going directly to reinsurers, with no role for the captive other than acting as a post box. However, this risks undermining the reliability of the reinsurance, as the captive is not complying with its fair presentation duties.

The extreme alternative is simply to transfer everything up to the reinsurer on the basis that everything they need is in the data, somewhere. However, that approach is likely to fall foul of the Act's prohibition of data dumping, meaning that the captive must now act as a proactive party, considering the information it has available and presenting this clearly and accessibly to reinsurers. Clearly, the obligations and liabilities here are considerable – and very new and untested.

What does this mean in practice?

There are obvious elements of 'house-keeping' that all captives should now be engaging in. An audit and policy review is a good place to start, to clarify the captive's current position and identify any issues.

Beyond that, the major challenge is one of ongoing governance. For those captive owners who set this process in motion now, there are considerable upsides in terms of the onward marketability of their risks to reinsurers and even the way in which risk is viewed more broadly within a company.

Mactavish has recently designed a legal and regulatory governance programme for captives and would welcome a chance to share this thinking with captive owners if they would like to reach out to us.