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Managing captive insurance in a social inflationary world

By John Ferrara and Margo MacKenzie

The insurance industry has experienced an increase in large-loss liability claims over the last few years. This increase has been widely discussed in public insurance company investor meetings and industry presentations, and increases have also been reflected in commercial insurance company rate indications and reserve studies. Many experts attribute the upward trend to increasing social inflation.

While social inflation has no precise definition, it generally refers to higher insurance liability claims, particularly 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 values of claim settlements and jury awards

Recent jury interviews suggest that social inflation is based on a growing belief in the importance of social justice. The desire for social justice is accompanied by individuals' feelings regarding a reasonable level of compensation and that compensation for injured parties should be significantly higher than it previously was. Social media has also influenced corporate behavior by pressuring businesses to take morally defensible positions or positions that will not show up in a social media blog with multiple supporters.

Social inflation is also impacted by the generational composition of juries. Currently, a larger portion of juries comprise millennials. Market research indicates that millennials typically have higher distrust for corporations and a higher propensity to determine larger awards as jurors. These jurors also tend to have a shorter attention span, as they have grown up in a rapid-fire, multitask, social media environment. Jurors with a shorter attention span may pay less attention to lengthy testimony and complex explanations and may ultimately make their award decisions based more on emotions.

Corporations today are also integrating social missions into their business operations and recruiting strategies for millennials and Generation Z talent. Since it has historically become more conventional for corporations to introduce ethical behavior, there may be a greater inclination to punish companies when individuals have been significantly harmed. The days of companies doing cost-based analyses on settling severe claims based on product weaknesses appear to be long gone.

It should also be noted that higher-valued worker salaries have grown by a larger amount than average employee salaries, which may also influence claim values in jurors' eyes. Younger individuals may be more inclined to see larger awards as more in line with damages. From 1978 to 2018, average CEO salaries grew by 940% to $17.2 million, while the average wage increase for high-valued workers grew by 339%. Meanwhile, wages for average-salaried employees have grown by just 11% in that same time frame.[1] These figures illustrate that millennials have grown up in a time when higher-valued workers make significantly more than they previously did. Similar increases can be seen for professional athletes and entertainers. These factors may impel younger individuals toward making larger jury awards.[2]

Current increases in social inflation are expected to have a permanent effect. The current issuance of higher awards may desensitize juries to these awards in the future as they become more commonplace. Insurance companies also have an increased propensity to settle at higher values, as the possibility of large awards under litigation changes company behavior. An example of this behavior is an instance when an umbrella carrier settled a claim for several million dollars to avoid litigation and potentially higher costs. The primary insurance carrier was unwilling to settle the claim, and on trial, no liability was found. The umbrella carrier settling in what was described as a clear case of no liability as advised and proved by the primary carrier clearly illustrates an increased propensity to settle based on fears of increased costs in a social inflation environment.

Other non-societal trends that may impact increasing social inflation include the incidence of nuclear settlements and third-party litigation funding. Nuclear settlements are defined as devastatingly large claim settlements where liability has little correlation to economic loss or prior settlement precedent and are often characterized as settlements of $10 million or higher. Wrongful death settlements associated with trucking claims have been observed in the $20 million range, and other large automobile claims for amounts exceeding $50 million have been reported. The concept of third-party funding of claims litigation relates to hedge funds and investment companies financing the plaintiff position of claims in exchange for a portion of the final settlement amount. This increasingly common funding mechanism enables a claimant and its legal counsel to obtain fees from an investment company to allow more time for them to pursue their claim and likely achieve a greater ultimate settlement value.

Many insurance lines of business are experiencing and will continue to experience the impacts of social inflation, including the following:

- Personal automobile and commercial automobile liability. There are numerous severe injuries and deaths associated with automobile insurance, many involving driver error or the use of a vehicle in a state of disrepair.
- Commercial general liability. Claims under this line involve bodily injury and property damage to third parties. These include product liability, premises operations and contracting claims. Each of these lines can experience very large jury awards associated with the most severe claims.
- Professional liability. These claims include employment practices insurance (EPLI), directors and officers claims, and medical malpractice claims. Increases in severe matters are most notable in the EPLI and medical malpractice sectors.

- Excess and umbrella liability. Insurance coverages, including those listed above, are often provided with a primary limit of coverage, typically $1 million. Excess and umbrella insurance coverages are provided for limits over and above the aforementioned primary limits. Instances where major companies are involved and major excess and umbrella limits are provided raise the potential for significant awards and payment of such awards.

Increasing social inflation should influence how captives handle both their claims and overall operations. First and foremost, risk managers and corporations should understand how attractive a target they may be. Litigation counsels will be knowledgeable of the company's financial means, its potential for reputational risk and its insurance coverage. In developing a defense strategy, jurisdictional factors should be taken into consideration. The difference in outcome by state has always been a relevant consideration, but jurisdictional analysis is an even higher defense priority now because of social inflation. Until recently, high-valued claims had experienced relatively stable trends and were not a major risk-management concern. That situation has changed.

Claims departments at captive insurance companies should consider segmenting potential high-impact claims and establishing a specific strategy to deal with them. One such strategy might involve assigning these claims to the proper levels of personnel and in-house review to mitigate loss and prevent a quick spiral to higher levels. Many captives utilize third-party adjustment firms and insurance carrier personnel for claims handling and captive management. Risk management personnel at captives should make certain they have a strategy in place to actively monitor large claims.

Captive insurance companies are usually established to manage risk efficiently. Captives achieve efficiencies by hiring company risk-management personnel to understand and control the exposures. Captives are also cost efficient, as they eliminate the margin and expense levels associated with the purchase of insurance company risk transfer policies. In today's environment, excess-of-loss coverages and the associated price/risk trade-off should be explored as claims begin to reach levels much higher than in the recent past. A company should model scenarios of one or a few additional shock losses at industry levels to determine whether such losses are manageable or whether high excess coverages should be purchased.

Captive insurance companies should also invest in exploring claim defense and settlement strategies in the increasing social inflation environment. Captive management should try to actively defend certain claims on a risk-reward basis. A captive insurer should guard against developing a reputation as one willing to settle all high-valued claims regardless of merit.

Captives have actuarial consultants or in-house actuaries to assist in the development of rate and reserve levels. Captive management should discuss the impact of social inflation on the relevant lines of insurance with its actuarial team. During recent years, the insurance industry has generally exhibited favorable-to-stable runoff of reserves, and pricing levels have followed suit (decreasing or remaining stable) for many captive insurance companies. This favorable environment may be changing. Captive insurers should monitor trends closely with their actuarial personnel to mitigate the downside potential in their rates and reserve levels. Inadequate loss reserve and rate levels can hinder management in managing, expensing and developing risk transfer mechanisms for captive programs.

The insurance world often exhibits loss and premium cycles that are driven by market forces. Social inflation is an important factor in the current environment. It is imperative for captive insurance management to become aware of the social inflation developments and establish a strategy to manage risk that may be significantly increasing in certain sectors.

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[1] Lawrence Mishel and Julia Wolfe, "CEO compensation has grown 940% since 1978," Economic Policy Institute, August 14, 2019.

[2] Debbie Stephenson, "When Did Athletes Start Getting Rich?," Touchpoint by Firmex, www.firmex.com/resources/uncategorized/when-did-athletes-start-getting-rich/, accessed May 2020.