# Environmental Financial Advisory Board

## EFAB



# The Use of Captive Insurance as a Financial Assurance Tool in Office of Solid Waste and Emergency Response Programs

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# The Use of Captive Insurance as a Financial Assurance Tool in Office of Solid Waste and Emergency Response Programs

## Background

The Environmental Financial Advisory Board (EFAB or Board) is examining, at the request of the U.S. Environmental Protection Agency (EPA or Agency), questions concerning the financial assurance requirements for Office of Solid Waste and Emergency Response (OSWER) programs. These requirements address closure, post-closure, corrective action and other aspects of the Resource Conservation and Recovery Act (RCRA) Subtitle C, D and I programs and also are viewed as guidance with regard to Superfund response action. Financial assurance requirements and the issues concerning them are complex and multi-faceted. For this reason, the Board, working with the Agency and other interested stakeholders, is addressing financial assurance mechanisms in discrete and manageable pieces, and focusing sequentially on them. This report addresses captive insurance, and focuses primarily on Subtitle C closure, post-closure, and third party liability requirements.

The Board was charged by EPA with addressing three questions regarding captive insurance: (1) Should there be minimum capitalization requirements for captive or other insurers who provide policies for financial assurance and, if so, what requirements would best assure funds are available for protection of the environment, including closure, post-closure, corrective action and other environmental clean-up?; (2) Should policies written by captives and commercial insurers be treated as equally acceptable mechanisms?; and (3) Should the language of policies written by captives differ in any way from those issued by commercial insurers?

In June 2004, EFAB conducted a workshop in New York City that began to explore the issues raised by the use of several financial assurance mechanisms, including captive insurance. On June 27, 2006, we convened a second workshop in New York City focused exclusively on captive insurance in which we heard from governmental and financial community representatives overseeing and evaluating the captive insurance industry, users of captive insurance, a representative of the EPA Office of the Inspector General, and three State government representatives familiar with the use of captive insurance for RCRA financial assurance. We received public comment at the meeting, and subsequently have received additional written comments from business interests and State solid waste management officials.

Our work has been informed throughout by the expertise of government officials willing to share their extensive knowledge of environmental insurance. In particular, we appreciate the insights provided by EPA staff in both OSWER and OECA, and State regulators familiar with the details of both RCRA and Superfund financial assurance requirements and the structure and operations of the captive insurance industry. The active participation of expert EPA staff and State representatives in extended discussions at the New York City workshop and in deliberations both before and after the workshop assisted the Board in understanding the nature of captive insurance regulation by State insurance regulators, and the regulatory framework for the use of insurance for financial assurance purposes under environmental law.

## The Concept of Captive Insurance

RCRA Subtitle C, D and I require that regulated facilities provide financial assurance sufficient to secure funds needed to meet program-specific obligations to properly close, conduct post-closure care or provide needed corrective measures. See, e.g., 40 CFR Sections 264.143 (e) (Subtitle C closure insurance), 264.145(3) (Subtitle C post-closure insurance), Section 264.146 (combination of closure and post-closure care insurance), 264.147 (Subtitle C liability insurance); 258.74(d) (Subtitle D closure and post-closure care insurance and corrective action). Superfund response actions also often require financial assurance and the RCRA regulations provide guidance in these instances. Insurance mechanisms are one option for meeting these requirements under Federal law. Available financial assurance options have included insurance since 1982 (see 47 Fed. Reg. at 15033 (April 7, 1982)).

Insurance mechanisms must assure that funds are available once closure or post-closure begins and in an amount sufficient to cover the current estimate of costs. The facility owner/operator "may receive reimbursements" as these activities proceed (see 40 CFR 264.146; 258.74(d)(4)). Although as a practical matter facility owner/operators may pay for closure/post-closure/corrective action as costs are incurred and not elect to draw on the insurance, the relevant federal or state regulator must have unimpeded ability to direct insurance funds as costs are incurred in the event that the policy holder defaults. While the language that must be used in an insurance policy for financial insurance is explicitly laid out in the regulations, these provisions do not impose any financial requirements or limitations on who may issue the policy.

There are two forms of insurance: "commercial" insurance and "captive" insurance. Captive insurance is distinguished by the initial funding and restriction of its coverage either to one company (so-called "pure" captive insurance where the parent establishes a captive for its exclusive use) or to an enterprise or risk retention group (e.g., brownfields redevelopment projects or a consortium of interests developing an affordable housing development). Captive insurance is used in areas other than environmental protection where corporate parent firms find it to their advantage to set up a captive to cover well-understood risks at a lower cost than purchasing insurance policies available from commercial carriers. Workman's Compensation has been cited as one area where captives are often used. The Board did not attempt to compare other risk areas where captive insurance is used with risks associated with environmental protection.

EPA's Office of the Inspector General in September 2005 summarized concerns which have been raised regarding the use of captive insurance for financial assurance purposes.

> "Captive insurance is defined as insurance issued by a wholly-owned subsidiary of the company being insured. The financial health of the captive insurance company is closely tied with the parent company, so if the company encounters

financial difficulties there is no guarantee that the captive insurance company would retain the necessary resources to fund closure and post-closure. This concern was expressed in our 2001 report and the ASTSWMO paper. Although we found no specific instances of financial assurance failure associated with captive insurance, States and regions remain concerned because there is no independence of risk between the corporate parent and the company insured." Office of the Inspector General, *Continued EPA Leadership Will Support State Needs for Information and Guidance on RCRA Financial Assurance*, Report No. 2005-P-00026, page 15-16 (September 26, 2005)(hereafter *2005 IG Report*)(updating and superseding a 2001 report by the Office of the Inspector General).

The remainder of this report describes specific issues raised in our discussions with stakeholders on this topic before turning to findings and recommendations. In particular, we summarize the States' specific concerns with captive insurance, as expressed in the June 27 workshop. These concerns were consistent with the recent EPA Inspector General's report summarizing State views on captive insurance. We then summarize the information provided by State governmental and financial community panelists with regard to captive insurance, as well as the views of companies who now use captive insurance. Finally, we offer our evaluation of the materials presented to us, and recommendations to EPA on how it can strengthen the reliability and transparency of captive insurance for financial assurance.

## State Concerns about Captive Insurance

According to the September 2005 Inspector General's report cited above, 13 states do not accept captive insurance as a financial assurance mechanism -- *2005 IG Report* at 14. A further reflection of this lack of confidence was that presentations at the June 2006 workshop suggested that other jurisdictions, while not prohibiting the use of captive insurance in principle, impose restrictive requirements on these policies which tend to make them noncompetitive and unavailable in practice.

The three State regulators participating in the New York workshop were consistent in raising concerns about captive insurance:

- Captive insurance is perceived to pose a high risk because of lack of independence (and thus true transfer of risk) between the captive subsidiary and its insured parent.

- State environmental regulators are concerned that captive insurers may not be subject to minimum requirements with regard to capitalization, minimal reserves or encumbrances on reserves (e.g., loans back or reliance on lines of credit).

- Where a captive insures an asset of declining value, like a landfill approaching capacity, there is no mechanism to compensate for the increasing risk of financial failure. State environmental regulators have limited experience with the insurance regulatory structure or with State insurance commissions. In general, State regulators thought that the assurance of quality oversight provided by independent third-party review and ongoing oversight (such as that provided by investment ratings for companies using the financial test, as recommended by EFAB in our earlier report) would be valuable. However, State regulators cautioned that the third party reviewing agency would need to fully understand the particular characteristics of the environmental risks being insured by a captive insurance firm.

- Where a captive is domiciled in a jurisdiction other than the State of the facility at issue, the host State is concerned about licensing requirements and continued oversight by the domicile jurisdiction's insurance regulators. States are concerned by the lack of consistent regulatory oversight in the states of domicile.

## <u>Testimony by the Captive Insurance Industry and Regulators</u>

The State of Vermont, which operates the largest domestic program for licensing captive insurance companies, provided extensive background on its activities. This discussion was supplemented by AM Best's presentation on the nature of their assessment of captive insurers' credit quality. The State of Vermont and AM Best shared the perspective that captive insurers are evaluated with regard to licensing with rigor equal to commercial insurers when evaluating the numeric fundamentals, with additional review of the quality of the parent employing a captive and of the business plan for the captive itself.

With regard to specific concerns raised about captive insurance, the panel representing State licensing and private sector oversight provided the following pertinent information:

1. <u>Understanding captive insurance licensing requirements</u>: Although the panel provided an excellent basis on which to improve understanding of captive insurance, they did not articulate in detail the practices of licensing programs by States other than Vermont, or by overseas jurisdictions which license captive insurers. Given that insurance is regulated at the State rather than the federal level, State insurance regulations are not uniform. One State's program may not provide enough of a framework by which environmental regulators can evaluate the quality of captive policies offered by organizations licensed in jurisdictions other than Vermont.

2. <u>Independence</u>: The panel stated that in their experience, in jurisdictions which do license captives, the factual terms of evaluation and requirements with regard to ability to cover claims are equivalent for captive and commercial insurers. These licensing practices, and the nature of rating agencies' oversight, also constitute a check upon parental control of and relationship with its captive. In addition, the State of Vermont imposes independent review authority on aspects of the captive's operations (e.g., the licensing authority must pre-approve loans, changes to the business plan, or changes in coverage). For captives rated by AM Best, there is an additional independent review, again of aspects of operations material to financial assurance (asset value and risk, credit risk exposure, loss reserves,

premiums written and, for captives, long-term performance, diversification and the financial strength of the captive's parent company).

3. Minimum requirements: As noted above, the State of Vermont and AM Best stated that they regularly review both commercial and captive insurers using equal standards with regard to capitalization, reserves, and encumbrances on reserves (e.g., Vermont must pre-approve loan backs and must have immediate and unencumbered access to evergreen Letters of Credit). However, the licensing jurisdiction for a substantial number of captives is outside of the United States. There are no universally recognized minimum standards. The requirements of the varying jurisdictions, both domestic and foreign, may vary considerably.

4. Risk of Failure: The financial assurance requirements for OSWER programs, at the federal level at least, do not have guidelines for minimum financial strength of the companies issuing insurance policies, commercial or captive. Both Vermont and AM Best evaluate diversification of assets and continually monitor asset value and risk. AM Best's rating process specifically analyzes the captive's ability to underwrite effectively, generate capital growth from ongoing operations and pay claims readily. On a stand-alone basis the captive insurer must have the financial means to support the policies written. Significant developments at the captive or the parent can result in rating change, reflecting the changed level of risk of failure.

5. Third Party Review: In response to questions, Vermont, AM Best, the insurance industry and State representatives agreed that third-party fiscal evaluation in the form of a secure rating from AM Best or comparable entities, or the parent's ability to satisfy the financial test (or possession of investment-grade credit with agencies such as Standard and Poor's and Moody's), is important corroborating evidence of fiscal soundness for companies seeking to use captive insurance.

## Users of Captive Insurance

The September 2005 Report by the EPA Inspector General summarized the views of the industry it polled as follows: "Industry representatives generally considered the financial assurance mechanisms to be adequate, at least for large companies." (*2005 IG Report* at 17). This view has been reiterated specifically with regard to captive insurance in comments to the Board in the public comment period and in written comments submitted subsequent to the June 27 meeting.

As mentioned above, industry representatives noted that some States refuse to allow the use of captive insurance for meeting financial assurance requirements. Users of captive insurance cited the following reasons why they did so:

- ability to obtain tailored insurance coverage at reasonable rates in a constrained commercial market;

- reduced costs (e.g., the risks are better understood and managed since the parent is expert in the risks insured, and captives' investment income can be used to cover losses); and

- access to the reinsurance market, although this market is limited for captives.

Written comments submitted on behalf of the Superfund Settlements Project and the RCRA Corrective Action Project described their members' views of the value of captive insurance as follows: "Captive insurance is a sophisticated and legitimate financial strategy that benefits the large and medium-sized insurance consumer by providing it with greater control over its risk programs, the ability to achieve cost savings and efficiencies that are passed on throughout its organization, and the opportunity to customize the type(s) of insurance coverage that it purchases." Superfund Settlements Project/RCRA Corrective Action Project, *Letter to Mary Francoeur and Stanley Meiburg, Environmental Finance Advisory Board* (July 28, 2006).

EFAB's ability to evaluate the current use of captive insurance was hindered by a lack of consistent national information on the extent to which captive insurance or other financial assurance mechanisms are used by private sector firms. Additional information on this topic may result from EPA's ongoing national initiative to improve compliance with financial assurance requirements and other ongoing Agency analyses.

## Findings and Recommendations of the Board

**Findings:**

Consistent with our findings with regard to use of the Financial Test for financial assurance purposes, we find that the use of independent credit analysis (i.e., credit ratings) is a cost-effective mechanism for demonstrating the financial strength of a captive insurer. Insurance credit rating institutions like AM Best distinguish secure from non-secure insurers, much as rating institutions like Moody's and Standard and Poor's distinguish investment from non-investment grade credit. These ratings help address the limited capacity of State regulatory bodies to undertake extensive credit analysis. It is important that the rating be current (reviewed within a specific length of time, perhaps the past year).

Because captive insurance has been of particular concern to a number of states, it is especially important that the licensing authority for any captive insurance firm allowed to write policies for use in meeting RCRA or Superfund financial assurance requirements for closure, post-closure care, corrective action or response action be rigorous and transparent in its procedures. The oversight program adopted by the State of Vermont appears to apply strong licensing standards for captive insurance companies. These standards include:

- Initial applications must be detailed and will not be approved unless the captive is capitalized sufficiently to meet its obligations.

- Application requirements include audited financial statements, actuarial certification of loss reserves calculated by an approved actuarial firm, annual reporting, parent company financial statements and regulatory detailed review by the jurisdiction of licensure.

- Enforceable requirements for pre-approval of loan backs (or up-streaming of dividends), change in business plan or claim coverage, and access to evergreen Letters of Credit (if used for capitalization) in the event of financial difficulty.

In addition, the Board agrees with Vermont officials about the importance of having sufficient staffing and funding resources to ensure effective oversight.

It is the Board's opinion that these safeguards, embodied in formal State rules and implemented with consistent and effective state oversight, strengthen captive insurance as a reliable means of providing financial assurance.

**Response to EPA's Charge:**

With regard to the three questions posed by EPA, the Board responds as follows:

(1) *Should there be minimum capitalization requirements for captive or other insurers who provide policies for financial assurance and, if so, what requirements would best assure funds are available for protection of the environment, including closure, post-closure, corrective action and other environmental clean-up?* The Board concludes that minimum capitalization requirements are necessary. It also concludes that a well-known and respected insurance rating agency, such as AM Best, is in the best position to determine what the minimum capital and surplus level should be for a particular insurer to assure availability of funds for the amount and types of risks being written.

(2) *Should policies written by captives and commercial insurers be treated as equally acceptable mechanisms?* Yes, assuming they meet licensing standards similar to those noted above with regard to the program implemented by the State of Vermont and are subject to effective, independent oversight.

(3) *Should the language of policies written by captives differ in any way from those issued by commercial insurers?* No. Policies issued to provide coverage for financial assurance purposes should clearly meet all applicable regulatory requirements, and the policy language should reflect the adequacy of coverage in all instances.

**Recommendations**:

The State of Vermont and AM Best have addressed many of the Board's questions about their written requirements for licensing of captives. However, at this time there is no standard requirement for captives to be either licensed in a jurisdiction with requirements equivalent to those imposed by either the State of Vermont, or by other independent review entities. It is understandable why States may not have full confidence in the use of captive insurance policies as a financial assurance mechanism absent comparable understanding of how these captive insurance policies work and are overseen by insurance regulators in jurisdictions other than Vermont, or by entities that are not certified by an independent third party ratings agency.

As a consequence, with respect to captive insurance as a financial assurance tool, the Board recommends that EPA require that:

(1) If the financially responsible affiliate uses a captive insurance policy to provide financial assurance, that the affiliate *either* (a) pass the financial test and unconditionally guarantee the obligations of the captive *or* (b) possess investment grade rating, or

(2) That the captive entity issuing the insurance policy have a rating of "secure" or better by AM Best or comparable rating agency.

(3) The rating of the captive must be formally reviewed by the rating agency annually, at a minimum, and the rating report must be furnished to those States where a captive policy is being used for financial assurance. Further, States must be notified within 30-days of a rating change, an outlook change, or a rating being placed under review.

The Board recognizes that a requirement with respect to ratings of entities issuing captive insurance policies has implications for commercial insurance firms as well. This is one issue that we expect to explore in subsequent deliberations.

The Board also recognizes that these recommendations could require additional EPA evaluative criteria. The Board has heard differing opinions about whether these criteria could be established through guidance, or whether notice and comment rulemaking should be pursued. The question of how the Agency should proceed is beyond the scope of the Board. We note that although rulemaking is strongly preferred by State environmental regulators, it can be time and resource intensive. We also understand that while guidance could be issued more quickly, it is not binding, and EPA cannot require more nationally consistent RCRA financial assurance measures in the absence of amended Federal rules.

One option the Agency could consider, in the absence of amended rules, is to develop information now which would assist State environmental regulators in evaluating entities issuing captive insurance policies whose parents would not now pass the financial test or who do not possess secure ratings themselves. This information could include examples of best practices by licensing agencies such as those cited above as practices by the State of Vermont. In creating this information, EPA could work with the State of Vermont, other States and international licensing boards to outline critical elements of regulatory oversight, articulate desirable working practices that may be insufficiently articulated in the formal regulatory framework, and provide guidelines to evaluate whether licensing agencies have sufficient resources to adequately enforce standards (e.g., fee for service to assure adequate staffing).
Of course, an entity that utilizes a captive may continue to satisfy the financial assurance requirements if it meets the financial test itself or secures the appropriate corporate guarantee. In such cases, it would not be necessary to consider the captive's rating.