
CAPTIVES Unleashed
MORE VALUABLE THAN EVER
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WRCIC 2024
WESTERN REGION CAPTIVE
INSURANCE CONFERENCE, LLC

Captive 101

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What Is a Captive?

- Definition
  - "An insurance company that has as its primary purpose the financing of the risks of its owners or participants." (Source: captive.com)
- No legal distinction between a captive and (re)insurance company
  - BUT they are generally regulated under separate legislation
- May (re)insure the risks of its owner, affiliated parties, or (within certain limits and using special structures) unrelated parties

What Does a Captive Look Like?

A captive functions like a regular commercial insurer by:

- Issuing policies to the policyholders (its parent, affiliates, fronting company, etc.);
- Collecting premiums;
- Disbursing claim payments;
- Producing its own financial statements; and
- Complying with the regulatory requirements of the jurisdiction in which it is domiciled.

Used as a risk management tool to assist its owner(s) with risk financing needs

Captures savings and / or generates additional profits for its owner(s)

Risk Appetite vs. Risk Tolerance

- Risk Appetite – Amount of risk a company is willing to accept to achieve its objectives
- Risk Tolerance – Acceptable levels of deviation from the company's risk appetite
- Risk Capacity – Maximum risk a company may bear and remain solvent

Risk Management

Risk Avoidance

Can a service or activity considered too risky be eliminated?

- Eliminate activities that involve risk
- Avoid creating activities that involve risk
- Relatively extreme approach

Risk Mitigation or Prevention

What steps can be taken to reduce the likelihood of losses occurring or lessen the impact of losses?

- Manage liability by structuring activities and programs in ways that reduce or limit institutional risk

Risk Transfer

Can risks or financial consequences of a loss be transferred to another party?

- Insurance policies
- Indemnification agreements
- Releases and waivers

Risk Retention

Accept the risk as it is – some risk is inherent in the activities of operation

- Self-insurance
- Deductibles
- Forego purchasing insurance

When Might a Captive Make Sense?

One or more of the following characteristics indicate a captive may provide value.

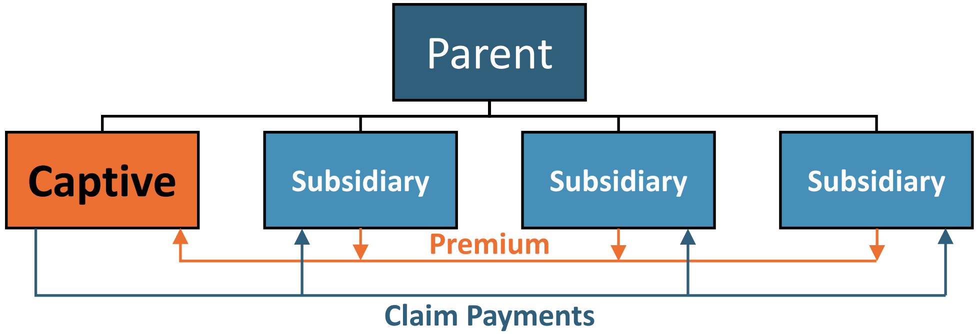
- Insurance program for the captive is of sufficient premium size
- Good and predictable historical loss experience
- Good loss control program in place
- Insured's loss expectation is lower than traditional insurance market
- Insured's risk is unusual and is often misunderstood or poorly coded by carriers
- Insured is seeking a profit center using insurance to generate an income stream
- The insured is looking for tax benefits similar to commercial insurance expenses

Captive Industry History / Overview

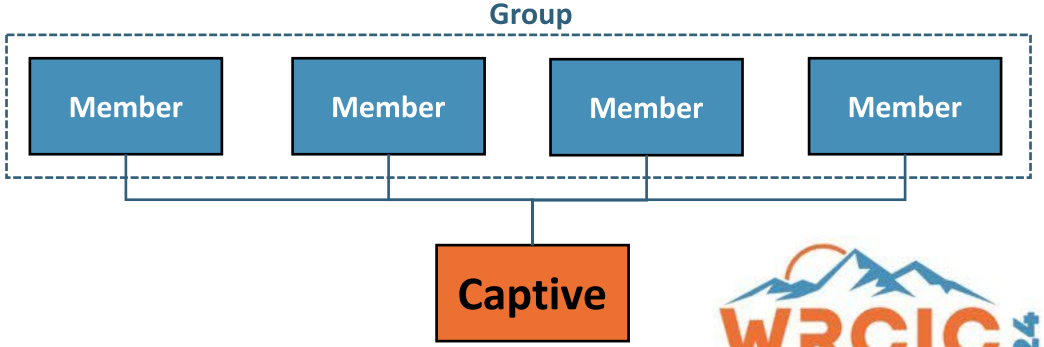
- The first captive was widely regarded to have been formed in 1962 in Bermuda
- Captives write ~$60 billion in annual premium
- Almost all Fortune 500 companies own at least one captive
- More than half of the 6,000+ active captives in the world are owned by USA companies / organizations

Most Common Captive Structures

- Pure Captive
  - Single entity, wholly owned within the same economic family
  - All risk co-mingled within one structure
  - Can be onshore or offshore

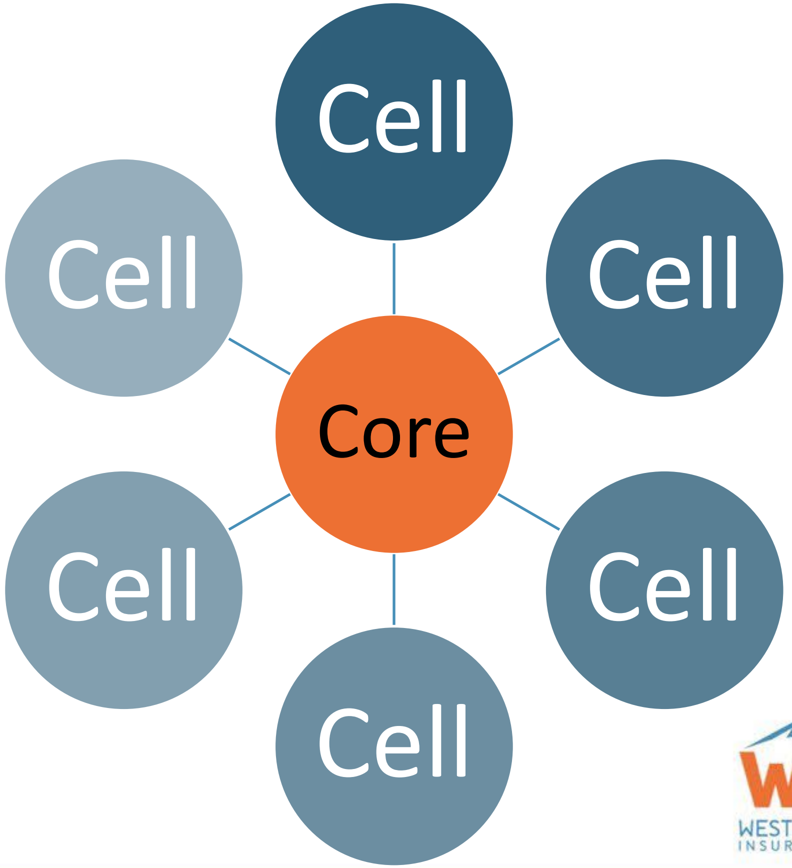


- Group or Association Captives
  - Entity owned by its member-insureds
  - All risk co-mingled within one structure
  - Historically more common offshore

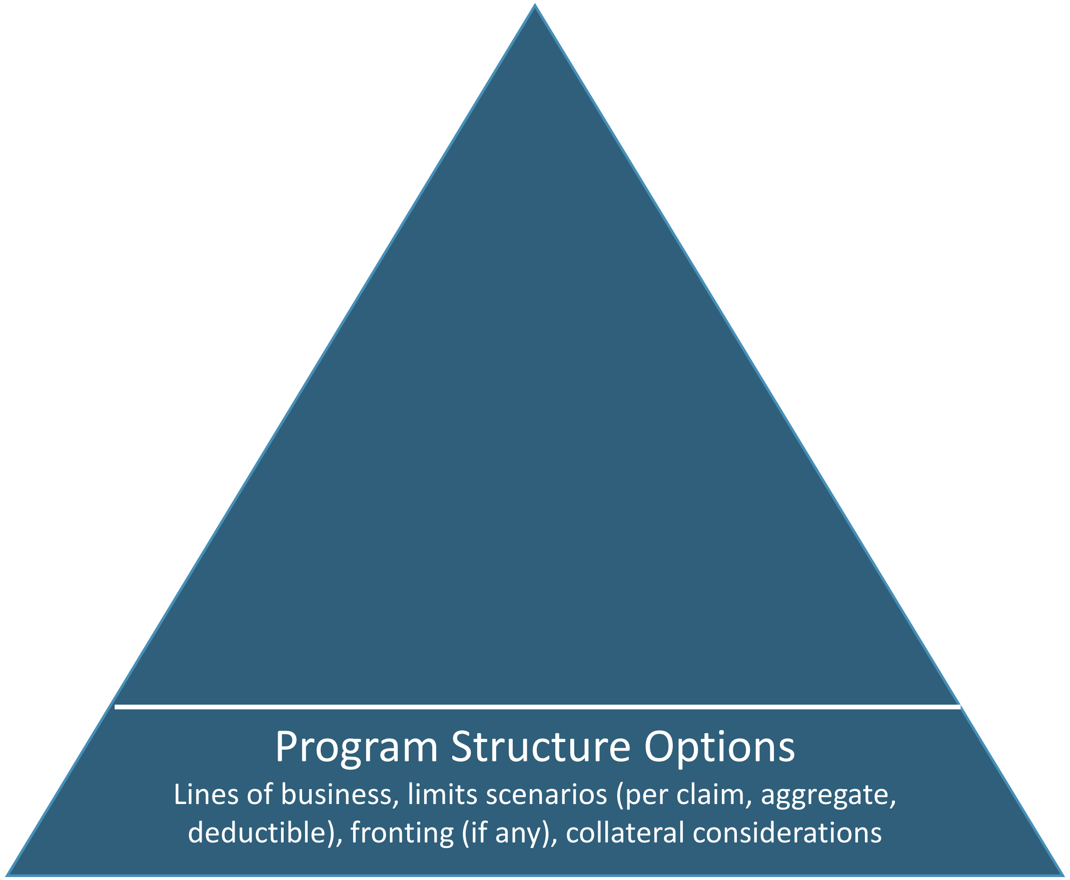


Most Common Captive Structures

- Protected Cell Captive
  - Can be a self-owned cell company or “rented” cell
  - Risks are segregated between cells
  - Can be onshore or offshore
  - Core capitalized by owner / sponsor
  - Individual cells likely to be fully collateralized if cell is affiliated with a third party



Program Structure – Foundation of Captive



Direct-Issue Program

Owner / Insured

- Captive owner identifies risks it wants to place in captive program, such as deductibles and uninsured risks

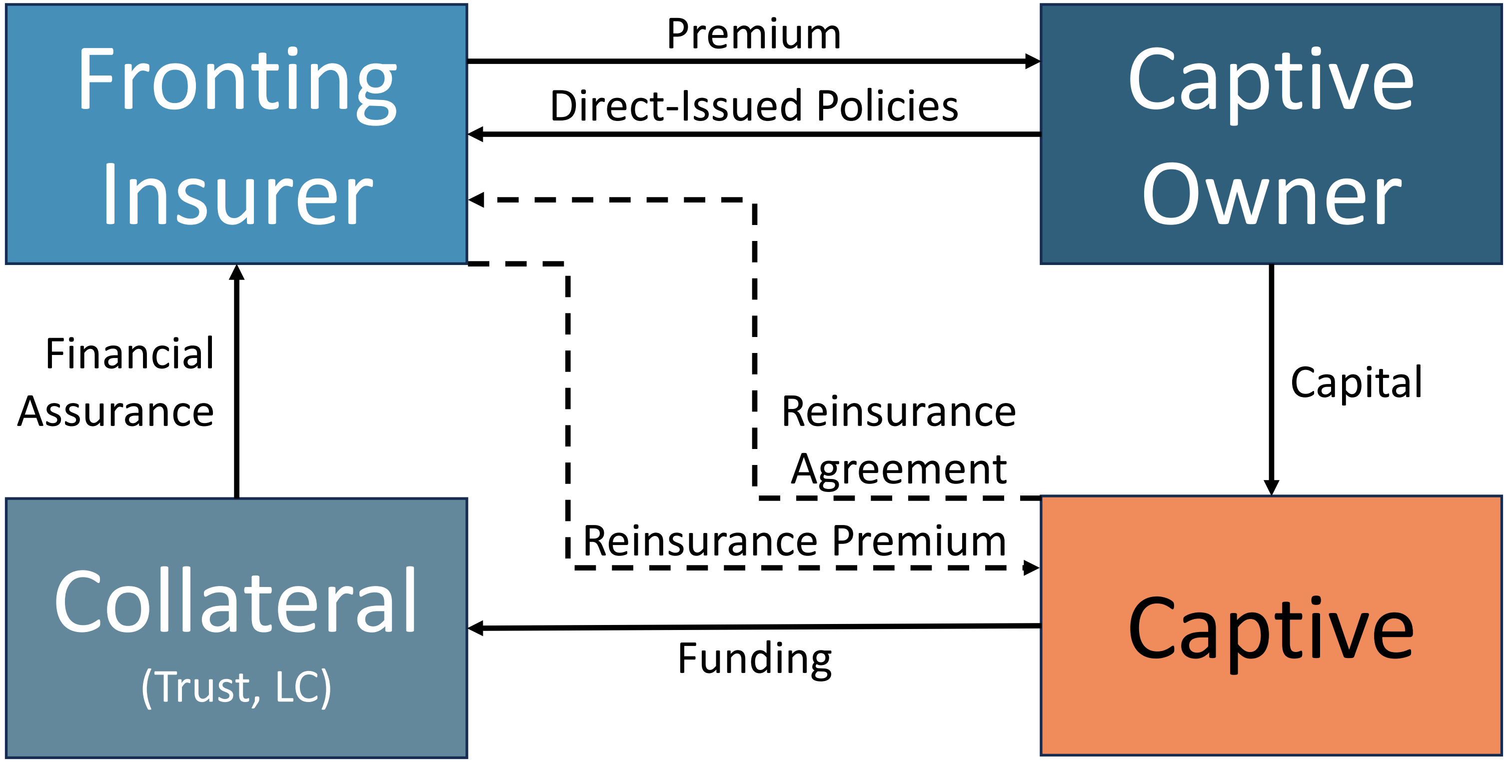
Captive

- Captive insurer issues policies, arranges claims-handling services, retains risk at agreed level

Reinsurer

- Captive may retrocede risk in excess of its desired retention

Fronted Reinsurance Program



Why Use a Front?

- Compulsory classes (regulatory)
  - Workers Compensation
  - Auto Liability
- Lenders require licensed paper (business reason)
- Captive selling policies to third parties (regulatory)
- Services of insurer required (business reason)
- Customers require it

Common Coverages Written by Captives

Traditional Risks

- Workers' Compensation
- Auto Liability
- General Liability
- Professional Liability
- Employment Practices Liability
- Environmental Liability
- Property and Business Interruption
- Self-Insured Medical Stop Loss (non-ERISA)

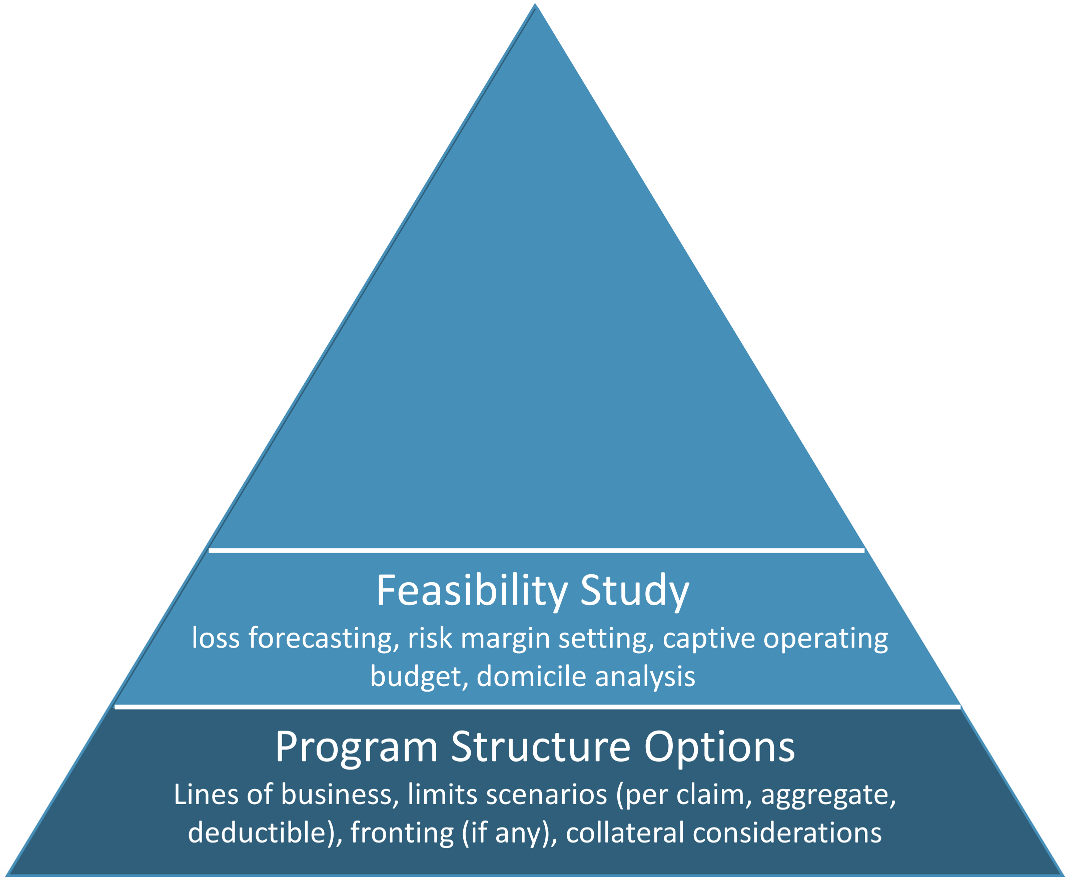
Expanded Risks

- Employee Benefits
- Terrorism (TRIA)
- Equipment Maintenance
- Construction Exposures
- Cyber-Risk
- Intellectual Property
- Warranty
- ERISA Benefits (Long-Term Disability, Group Life, etc.)

Enterprise Risks

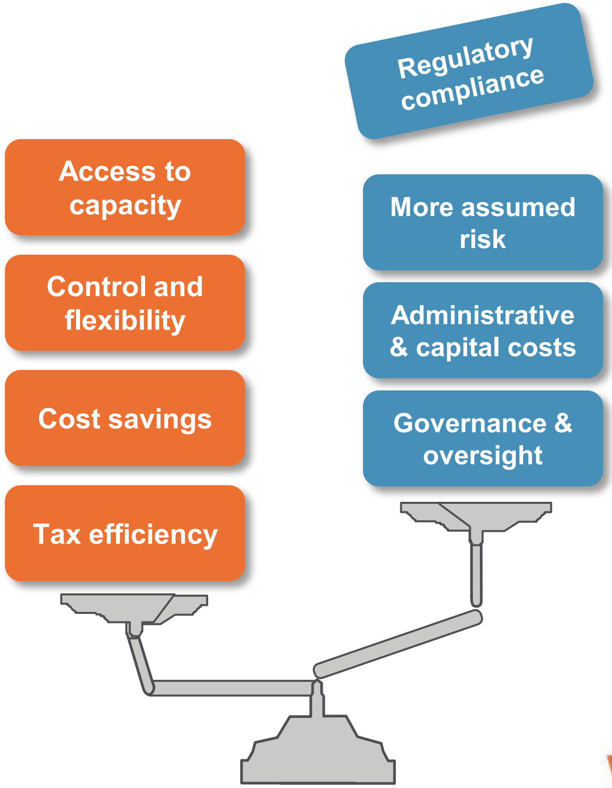
- Difference in Conditions / Difference in Limits
- Reputation/Brand/Recall
- Intellectual Property (Patent, Trademark, Copyright)
- Punitive Damages
- Key Person
- Loss of Key Customer / Contract / Supplier

Feasibility Study – Start of Captive Formation



Feasibility Study: A Cost-Benefit Analysis

- Primary Benefits
  - Save premiums / access reinsurance capacity
  - Greater control & flexibility
  - Material costs savings
  - Tax benefits
- Key Considerations
  - Alignment with the risk appetite and risk bearing capacity
  - Assessment of the additional capital tied-up in the new entity
  - Assessment of your incorporation costs and ongoing administration costs.
  - Selection of optimum domicile



Typical Feasibility Study Process

Step 1: Define business objectives and assess initial viability

- Discuss the fit between business objectives and captive strategy
- Collect relevant information
- Review the current profitability of the selected lines of insurance
- Determine the appropriate lines to consider for the captive

Step 2: Analyze insurance program and identify opportunities

- Assess the captive's opportunity to participate in the risk management program
- Forecast losses for those lines under consideration
- Evaluate potential risk margin by line of coverage, including consideration of the nature of the risk

Step 3: Create feasibility study output

- Build preliminary captive operating budget
- Perform a robust cost benefit analysis
- Review of multiple alternative domiciles
- Prepare financial statements for regulatory submission
- Establish capital requirements

Timeline is typically 6-8 weeks to complete all three steps for a standard pure captive. More complex captives may take an additional 2-4+ weeks.

Value Captives Derive for Their Owners

Reduced Insurance Premiums

- Profitable premium retained in captive
- Captive provides access to reinsurance capacity not available on a direct basis (e.g., buying wholesale)
- Reduce or remove fronting costs

Maximized Working Capital

- Proactively manage captive cash-flow
- Continuous process to improve operational efficiencies in order to drive lower expense structure
- Accelerated claims payments to improve cash flow and reduce frictional costs

Increased Value from Service Providers

- Captive owners have more control over the insurance program
- Having a captive gives leverage in negotiations with commercial carriers
- Outsourced services can reduce and control internal administrative costs

Improved Risk Retention, Transfer, and Mitigation Decision Making

- Captive delivers accurate and timely management information
- Bespoke policy wordings to enhance coverage and remove exclusionary language
- Connected decision making

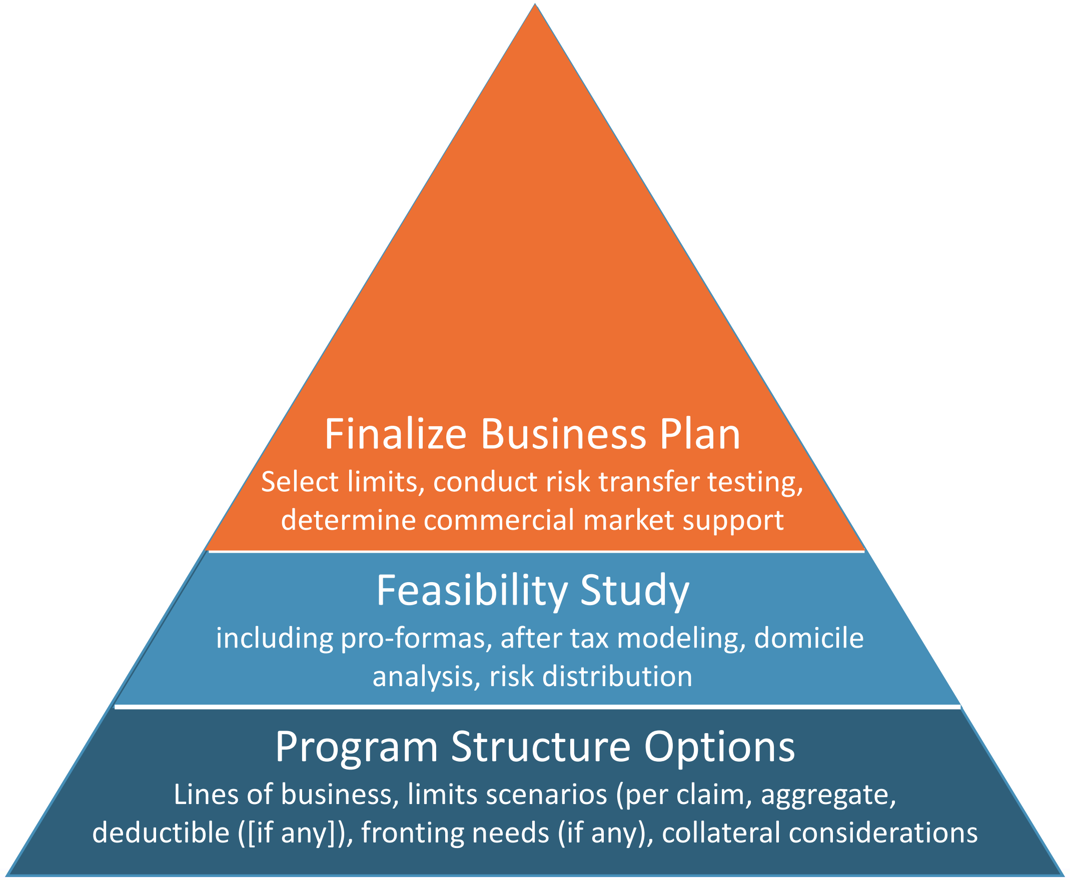
Domicile Selection Criteria / Considerations

- Regulatory staffing, experience, and reputation
- State (self-procurement) and federal premium and income tax implications
- Formation and ongoing capital requirements and operating costs
- Captive premium taxes / fees
- Investment restrictions (certain types of captives only)
- Reporting and / or audit requirements
- Quality and capacity of local service providers

Onshore or Offshore?

	Onshore	Offshore
Pros	• Regulatory relationships • Lower travel cost and time • Premium & federal excise tax efficiency • Perception	• Broader program structuring optionality • More flexible investment regime • Income tax advantage if assets remaining offshore
Cons	• More restricting underwriting and investment guidelines	• Controller Foreign Corporation disclosure requirements • Higher operating & travel costs • Repatriating assets tax-efficiently

Finalize Captive's Business Plan



Finalizing the Business Plan

Structure	• Select deductibles as well as per claim, policy, and program aggregate limits • Identify risk transfer testing parameters, adjust premium as necessary
Marketing	• Finalize how captive will dovetail with use of traditional insurance • If necessary, market traditional insurance placements needed for captive program
Audit & Tax	• Give consideration to various audit topics (see next slide) • Determine captive's likely income tax position, premium tax regime(s)

Audit Considerations

- Type of opinion: letter of credit, loss disclosure considerations
- Claim processes: internal or TPA
- Related party transactions: agreements, cash movement
- Investments: policy, type of investments

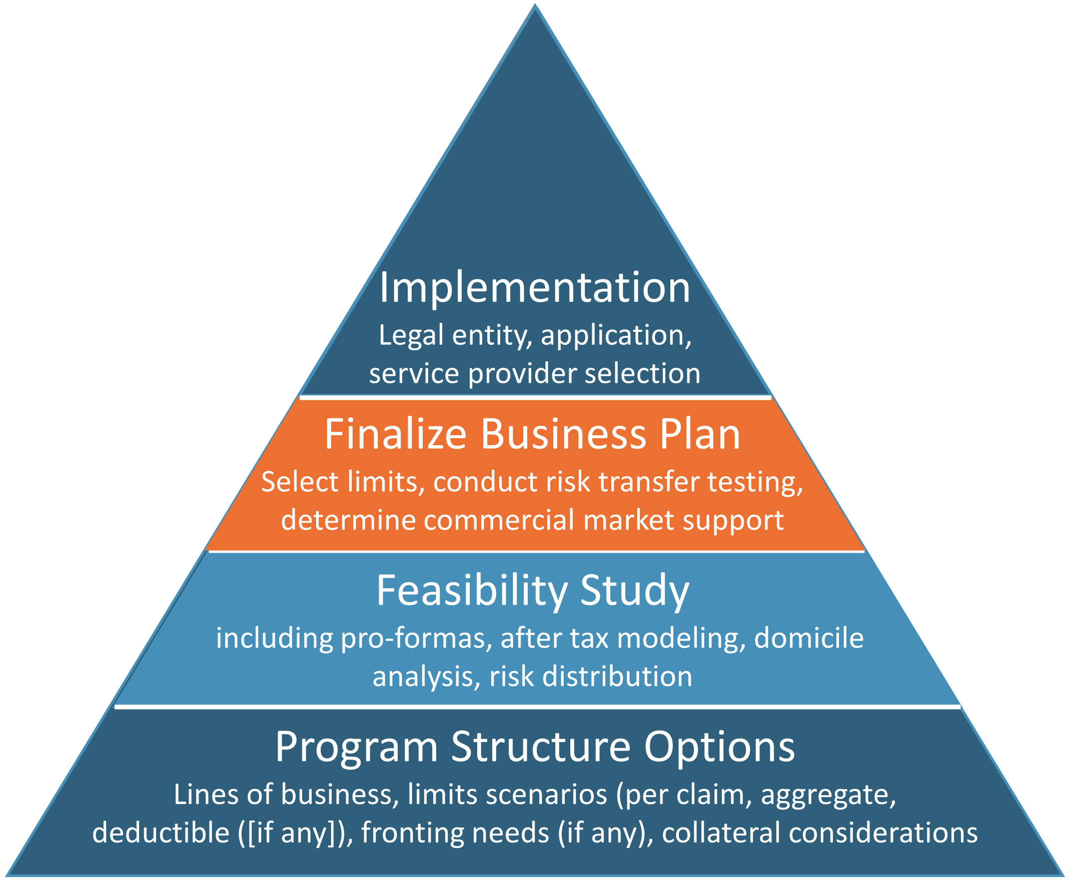
Tax Considerations

- IRC §831 (a): taxed as a regular insurance company
- IRC §831 (b): taxed as a small insurance company – only on investment income, premium limitations
- IRC §953 (d): election for foreign insurance company to be treated as a U.S. entity for tax purposes, specific rules and processes that must be followed

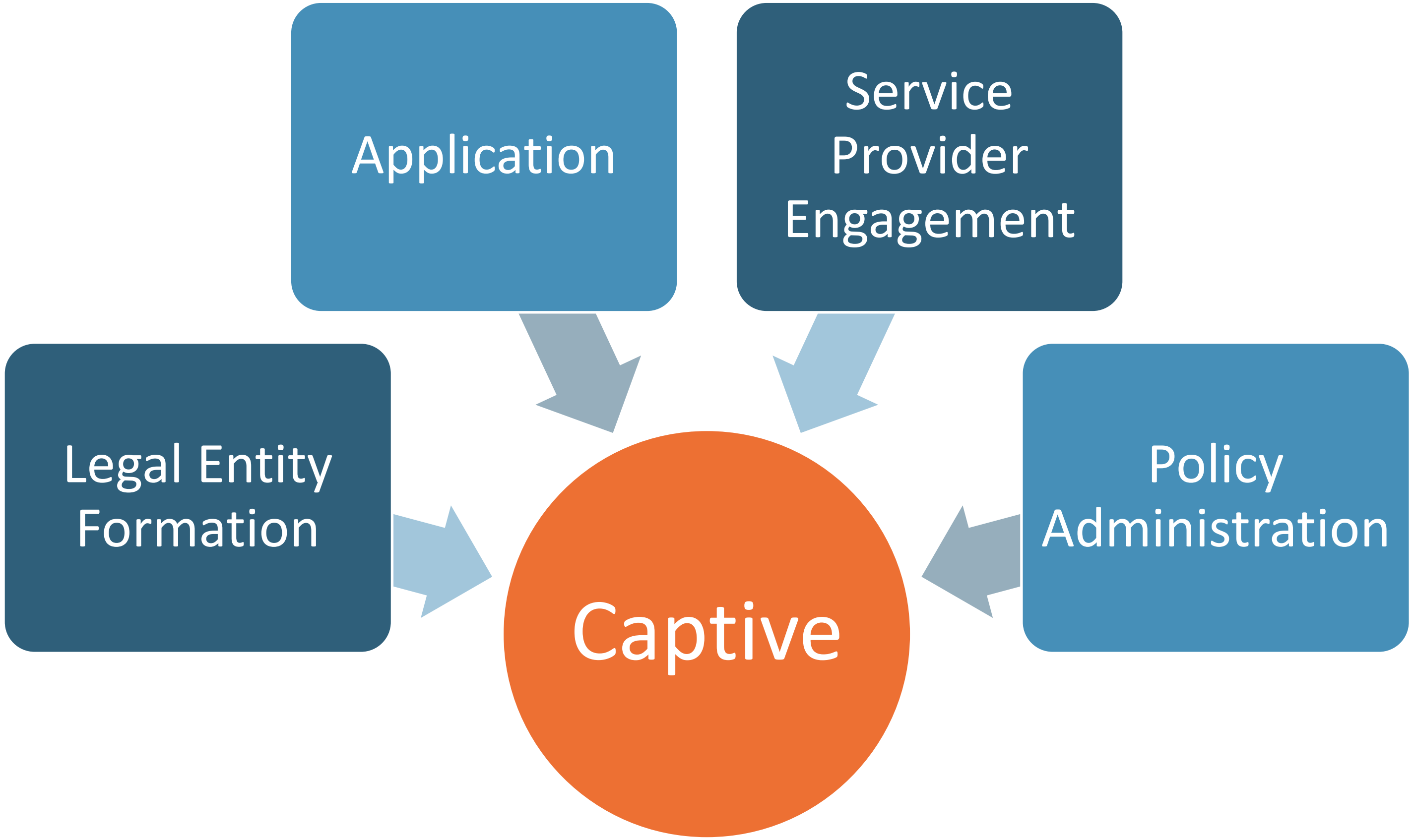
Tax Considerations

- Insurance Company Requirements
  - Risk Distribution
  - Risk Transfer
  - Insurance Risk
  - Function as an insurance company
- Book vs. Tax: usually clear risk transfer, but less clear risk distribution
- Consolidation with parent: tax allocation agreement

Implementation

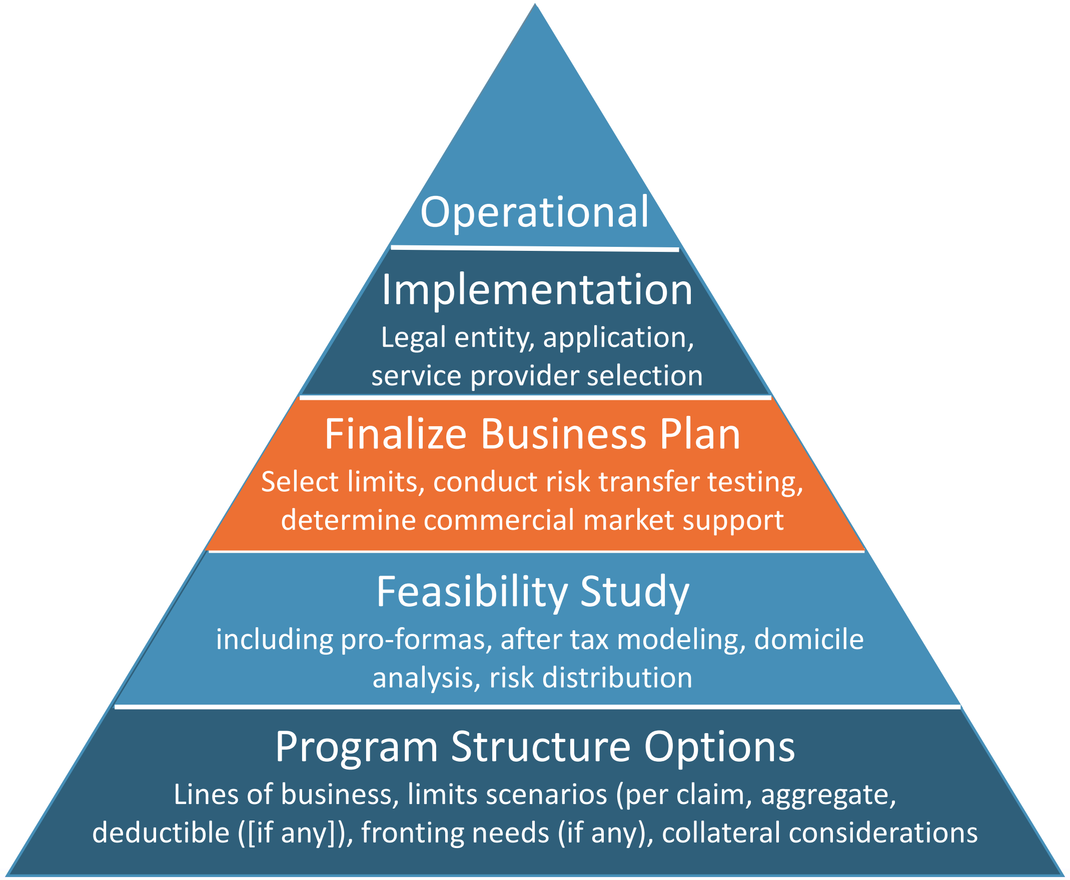


Implementation Processes Can Be Run in Parallel



Service Provider Orbit

Captive Becomes Operational!



Ongoing Operations of Captive

- Financial updates
- Regulatory filings and compliance
- Board meeting
- Annual audit
- Renewals
- Investment updates and policy adjustments
- Deployment of surplus: permanent distributions, non-permanent distributions, and…
- …EXPANSION!

Case Study A

Problem

- Traditional insurance getting more expensive
- Rapid organizational growth

Solution

- Captive funds increased self-insurance
- Leverage organization's financial ability to take on more risk

Result

- Reduce total cost of risk by 20%
- Attract more carriers to bid on risk transfer

Case Study B

Problem

- Market reclassifies general liability exposures
- Increased retentions, sublimits on certain categories

Solution

- Replace primary layer with fronted captive program
- Increase control over claims handling and selection of counsel

Result

- Lower total cost of risk by 15%
- Reduce reliance on traditional insurance market
- Insulate captive owner from market swings

Questions?