WRCIC
WESTERN REGION CAPTIVE INSURANCE CONFERENCE, LLC

Viva la captives!

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# An Introduction to Captive Insurance


***Panelists:***

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## 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




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# Risk Management

**Risk Avoidance**

Can you eliminate a service or activity considered too risky?

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

**Mitigation or Prevention**

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

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

**Risk Transfer**

Can we transfer either the risk or financial consequences of a loss 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
- Deciding not to purchase an insurance policy for a specific reason



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## What is a Captive?

- **Definition…**

  "Closely held insurance company whose insurance business is primarily supplied and controlled by it's owner and affiliates who are its principal beneficiaries"

- No legal distinction between a captive and an insurance or reinsurance company
  - *BUT they are regulated under special legislation in the U.S. or offshore*
- May insure or reinsure the risks of its owner, affiliated parties or unrelated parties



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# What Does A Captive Look Like?

A captive functions like a regular commercial insurer by:

- Issuing policies to the policyholders (the parent, affiliate, etc.);
- Collecting premiums;
- Disbursing claim payments;
- Preparing balance sheets and income statements;
- Complying with the regulatory requirements of the jurisdiction in which it is domiciled.




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# Indications Forming a Captive Might be Appropriate

- ✓ Insurance program for the captive is of significant premium size
  - ✓ At least $1m;
- ✓ 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;
- ✓ Insured is looking for tax benefits similar to commercial insurance expenses.



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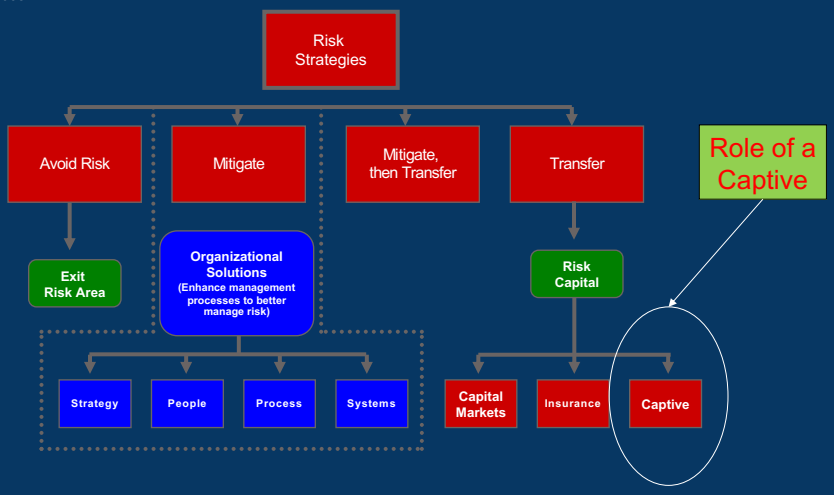
## Where Does a Captive Fit Within the Wider Risk Strategy?

One of Many Pieces…



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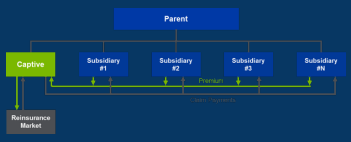
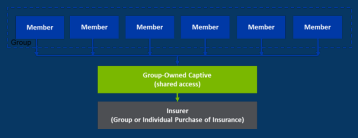
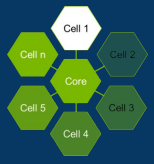
## Captive Structures

- **Single Parent Captive**
  - Single entity wholly owned
  - All risk co-mingled within one structure
- **Group or Association Captives**
  - Entity owned by its members/insureds
  - All risk co-mingled within one structure
- **Protected Cell Captive**
  - Can be a self-owned cell company or "rented" cell
  - Risks are fully segregated between cells
  - Core capitalized by owner
  - Individual cells likely to be fully collateralized
- **Risk Retention Group**
  - Type of group captive
  - Must be formed in a U.S. state
  - All insureds must be owners/all owners must be insured
  - Can write only liability coverage
  - Regulated in one state/registered in others



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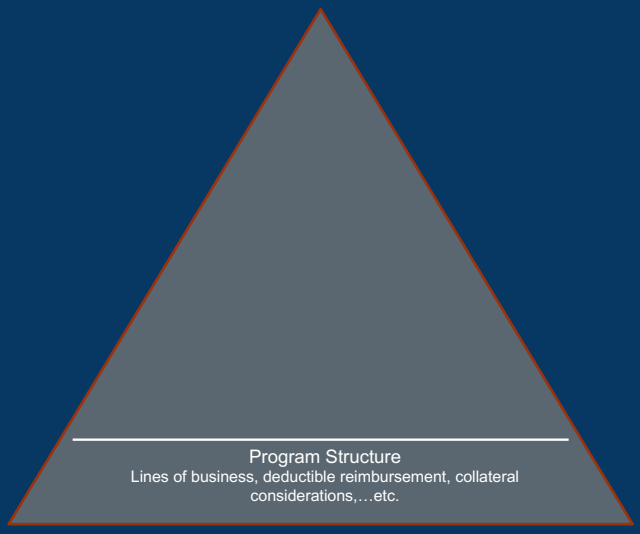
## Program Structure – the Foundation of a Captive Program



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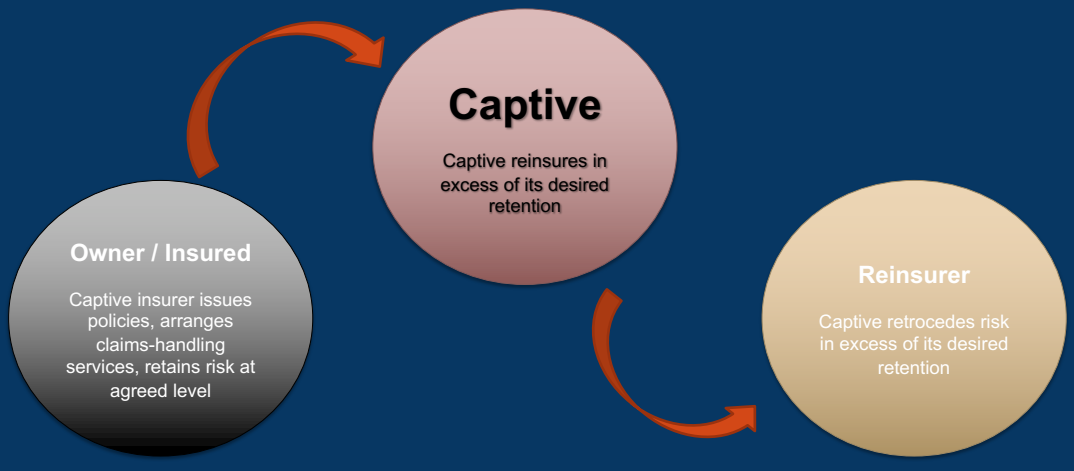
## Direct-Issue Program



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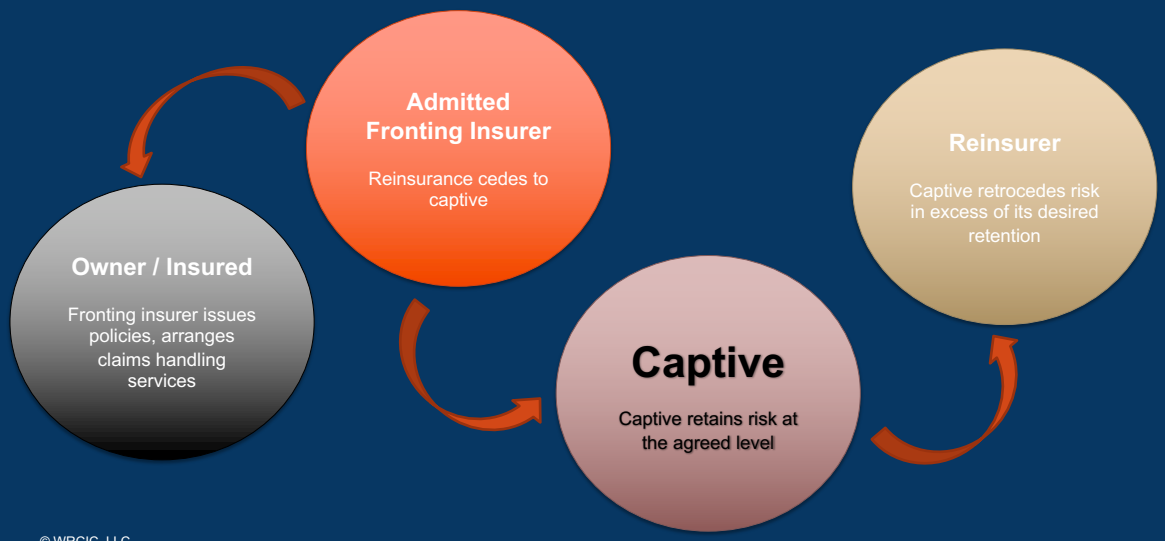
## Fronted Reinsurance Program



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## 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



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## Onshore or Offshore?

| | Onshore | Offshore |
|---|---|---|
| **Pros** | • Regulatory relationships<br>• Lower travel cost and time<br>• Elimination of some frictional taxes<br>• Perception | • Greater coverage flexibility<br>• Generally more flexible investment regime<br>• May provide an income tax advantage<br>• Some domiciles have long history/stability |
| **Cons** | • More restricting underwriting and investment guidelines<br>• Some domiciles regulate few captives | • Higher operating costs<br>• Higher travel costs<br>• Perception<br>• Cross border transactions subject to more scrutiny/reporting |



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## Captive Uses

| Traditional Risks | Expanded Risks | Emerging Risks |
|---|---|---|
| ■ Workers' Compensation<br>■ Auto Liability<br>■ General Liability<br>■ Property Ins.<br>■ Professional Liability<br>■ Employment Practices Liability<br>■ Environmental Liability<br>■ Property and Business Interruption | ■ Employee Benefits<br>■ Terrorism (TRIA)<br>■ Equipment Maintenance<br>■ Construction Exposures<br>■ Cyber-Risk<br>■ Intellectual Property<br>■ Warranty | ■ Self-Insured Medical Stop Loss (non-ERISA)<br>■ Reputation/Brand/Loss of Income Risks<br>■ Intellectual Property (patent, trademark, copyright)<br>■ Punitive Damages Protection |



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## The Value Captives Deliver for Their Parents

Captives contribute to long-term profitability and continuity by helping manage, control, and reduce Total Cost Of Risk (TCOR).

### 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

### Maximizing 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

### Managing Quality and Cost of Outside 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



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How to Get Our Arms Around All of the Moving Parts?

The Captive Feasibility Study



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## Feasibility Study – First Step of Captive Formation




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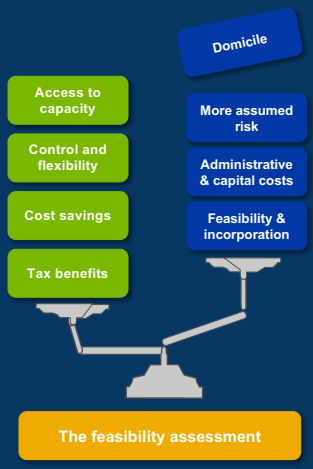
## Feasibility Study: A Cost-Benefit Analysis

**Primary Benefits**

1. Save premiums / access reinsurance capacity
2. Greater control & flexibility
3. Material costs savings
4. Tax benefits

**Key considerations**

1. Alignment with the risk appetite and risk bearing capacity
2. Assessment of the additional capital tied-up in the new entity
3. Assessment of your incorporation costs and ongoing administration costs.
4. Selection of optimum domicile



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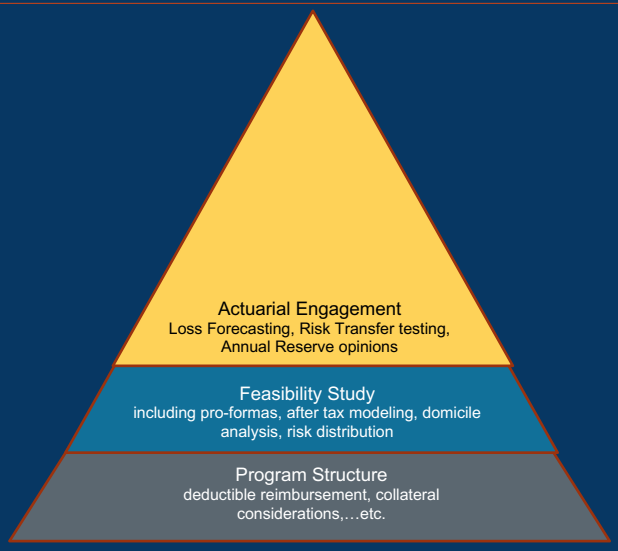
## Actuarial Engagement – Supporting the Captive's Business Plan



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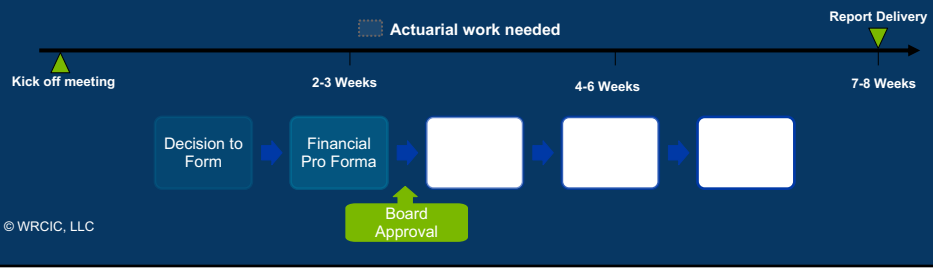
## Typical Feasibility Study Process & Timeline

| *Phase I* | *Phase II* | *Phase III* |
|---|---|---|
| **Define business objectives and assess initial viability** | **Analysis of insurance program and identify opportunities** | **Creating the feasibility study output** |
| 1. Discuss the fit between business objectives and captives | 1. Assess the captive's opportunity to participate in the risk management program | 1. Perform a robust cost benefit analysis |
| 2. Collect relevant information | 2. Forecasting retained loss costs for those lines under consideration | 2. Review of multiple alternative domiciles |
| 3. Review the current profitability of the selected lines of insurance | 3. Measure preliminary tax opportunities | 3. Prepare financial statements for regulatory submission |
| 4. Determine the appropriate lines to consider for the captive | 4. Address captive structure/model | 4. Establish capital requirements |



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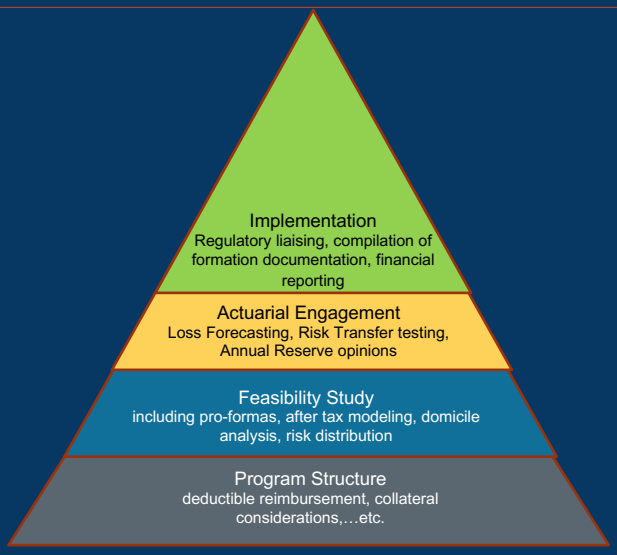
## Implementation



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## Route to Captive Implementation and Operation

- **Business Plan**

**Domicile**
- Captive Name
- Directors & Officers
- Domicile Meetings
- Proposed Service Providers

**Financial**
- Tax Position, Capitalization, Premium
- Pro Formas

**Internal Approvals**
- Tax, Legal, Auditor
- Attend Pre-incorporation Meetings
- Establish Investment Policy

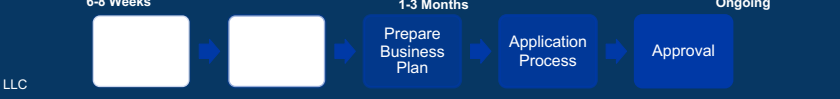
**Prepare/Review Legal Documents**
- Plan Exhibits / Policies
- Prepare Plan Narrative

- **Application**

**Pre Application Meeting**
- Review proposed Business Plan
- Discuss purpose, capital, limits, premiums
- Attendees

**Application**
- Include Business Plan
- 30 day review
  - Additional data restarts clock
- Review by DOI
- Q&A
- Approval granted
  - May be subject to additional items

- **Approval**
- EIN obtained
- Cash/Capital moved to bank
- License issued
- Pay License fees
- Organize Board meeting
- Commence operation….
  - Issue policies
  - Accept premium
  - Pay losses
  - Adopt corporate policies
  - Board education on legal, tax and regulatory matters



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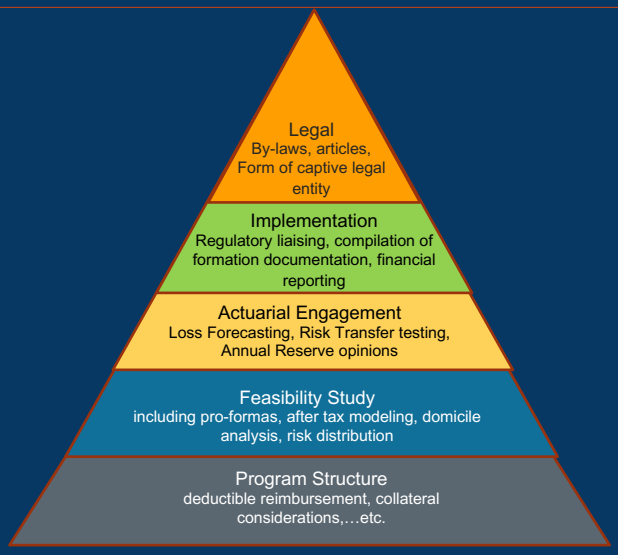
## Legal – Forming the Captive as an Entity



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## Ongoing – All Parties can be Involved

**Change in program structure requires a business plan amendment**

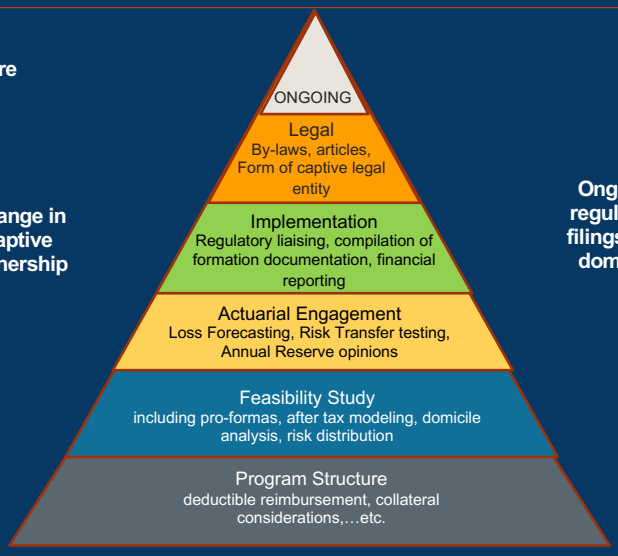
**Change in captive ownership**

**Determining captive dividend amount and obtaining regulatory approval**

**Policy renewals and annual premium determination**

**Ongoing regulatory filings with domicile**

**Regulatory approval for captive loaning back assets to parent**



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## Factors for Success

- Management commitment and attention
- Long term view
- For groups, glue and incentives
- Focus on loss mitigation
- Sufficient capital



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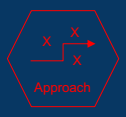
## Case Studies

**Optimize Insurance Program**


**Problem:** Historically low retentions were cost-inefficient and company had large exposures for uninsured risks




**Solution:** Utilize actuarial analytics and market inputs to identify opportunities to strategically increase retentions and quantify uninsured exposures


**Benefit:** Captive used to fund for increased retentions and create insurance programs for previously uninsured risks

**Reduce Reliance on Market**


**Problem:** Substantial increase in commercial market pricing for Property program – coupled with record breaking revenues during COVID driven by certain business units


**Solution:** Use captive to fund a substantially increased retention position – while leveraging balance sheet strength of company to take on increased exposures


**Benefit:** Reduced total cost of risk by about $1M and attracted better quality carriers to participate



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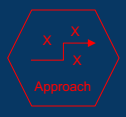
## Case Studies (cont'd)

**Support Excess Risk Transfer**


**Problem:** Challenging casualty renewal with primary decreasing limits

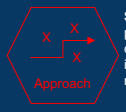



**Solution:** Short-term, utilize a segregated cell to insure a buffer layer between primary and excess attachment. Long-term, intend to explore single-parent captive.


**Benefit:** Filled out insurance tower and satisfied excess carrier requirements to evidence insurance

**Greater Control Over Program**


**Problem:** Substantial increase in commercial market pricing for General Liability plus increased retentions, particularly for certain claim categories




**Solution:** Replace primary layer with fronted captive program to insulate from hardening market


**Benefit:** Reduced total cost of risk by over $500k and increased control over claims handling and legal counsel selection



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# Questions or Comments?

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