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Should a Captive be in Your Future?

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Session Description:

Captive insurance companies are becoming more common among Universities and Special Districts and have potential for cities and counties. Captives are not just a different form of self-insurance. You are creating and operating your own insurance company, an insurance company with great flexibility to meet your specific coverage needs. More importantly, using a Captive creates visibility and ownership among your key decision makers. A Captive may provide just what you need.

Attendee Takeaways:

1. Compare Captives and their capabilities to other forms of alternative risk financing
2. Identify the types of risks and coverages that may be appropriate for your Captive
3. Understand the process for setting up a Captive

Common Misconceptions

1. Captives are only formed for tax savings
2. Captives are only formed in hard markets
3. Only Fortune 500 companies form captives
4. Captives don’t pay tax
5. Only certain industries use captives
6. The most popular domiciles are “tax shelters”
7. You can only use captives for certain risks
8. Captives are expensive to run
9. It takes a long time to set up a captive
10. You need a certain level of risk to justify a captive

What Is Risk Financing?

Achievement of the least-cost coverage of an organization's loss exposures, while ensuring post-loss financial resource availability. The risk financing process consists of five steps:

1. identifying and analyzing exposures,
2. analyzing alternative risk financing techniques,
3. selecting the best risk financing technique(s),
4. implementing the selected technique(s),
5. and monitoring the selected technique(s).

Risk financing programs can involve insurance rating plans, such as retrospective rating, self-insurance programs, or captive insurers.

- IRMI Website

What Is Alternative Risk Financing?

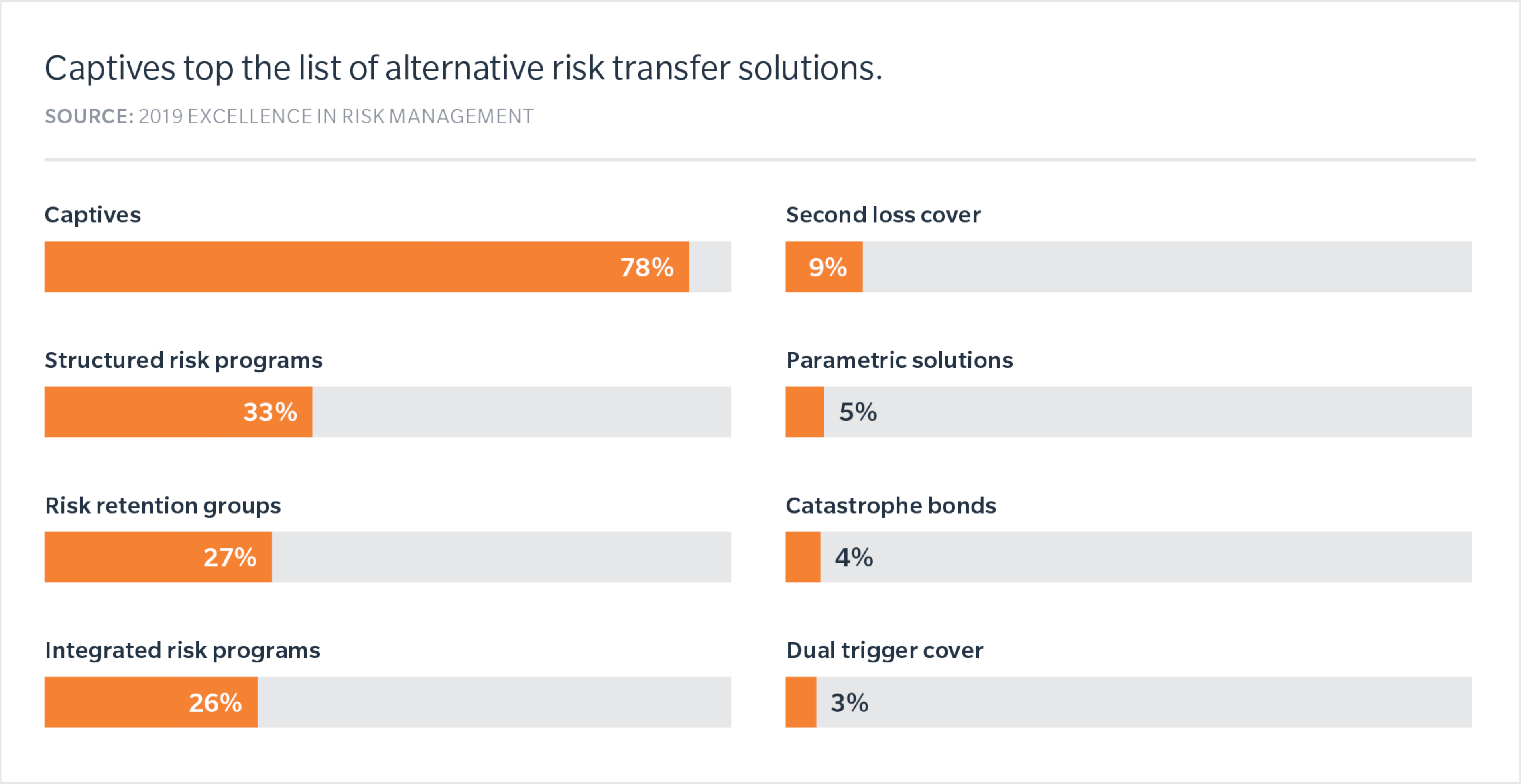
Alternative Risk Financing Mechanism:

A legal entity, such as a captive insurance company, that assumes from one or more entities the liability to pay their future losses; used as an alternative to commercial insurance.

- IRMI Website

Alternative Risk Transfer Solutions

According to a recent Marsh survey, 78% of companies that say they use some form of alternative risk transfer use captives.



Source: [2019 Excellence in Risk Management]

Why Not Just Self-Insure?

- Access to broader insurance marketplace
- Elevate risk management in the organization
- Personal attention of C-Suite as board member
- Ring-fence funds
- Finance loss control and safety programs
- Regulated environment
- Ability to evidence Additional Insured status

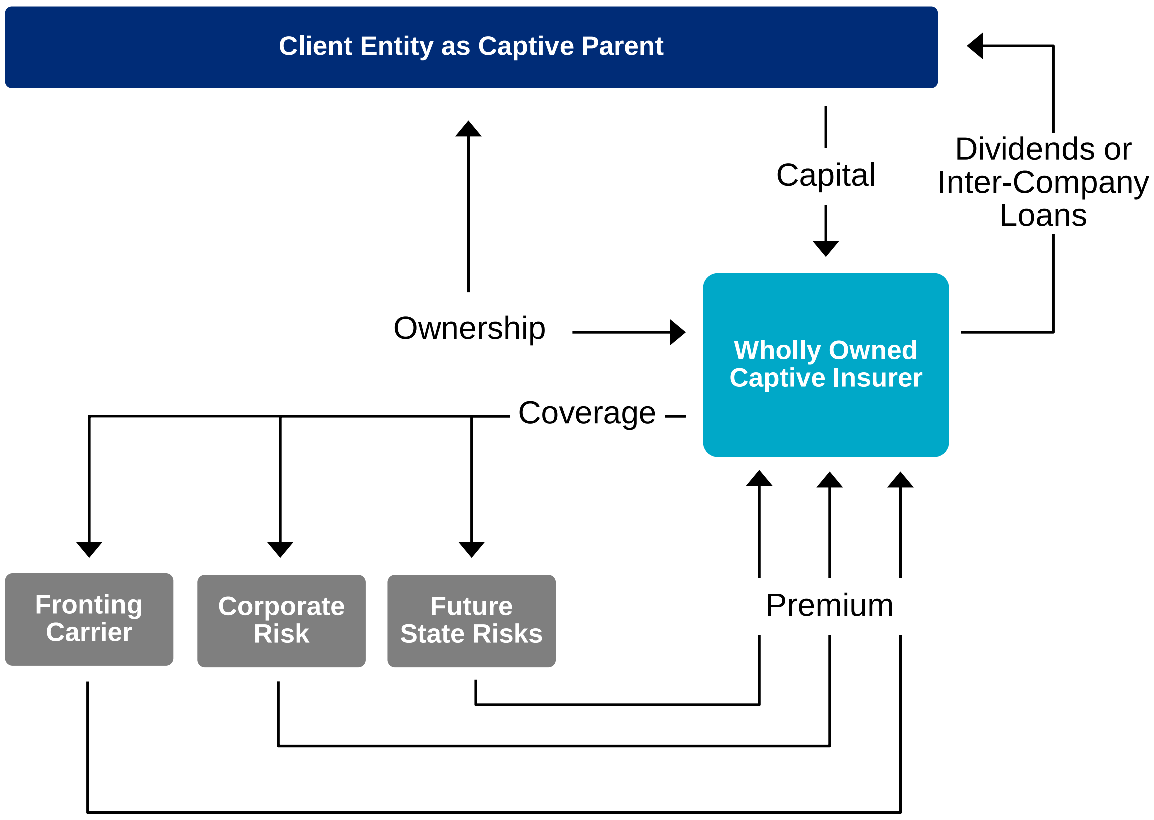
Widely Accepted Definition

A captive insurance company is a <u>bona fide</u> licensed insurance or reinsurance company owned by a non-insurance company and which insures or reinsures the risks of its parent or affiliated companies

Simply put – it is a formalized mechanism to finance self-insured risks.

The captive may retrocede reinsurance at an acceptable level to the commercial reinsurance market.

Capitalization requirements and captive's net retention are important to consider early on.



Potential Reinsurance Structure

Public Entity

Fronting Insurer

Client-Owned Single Parent Captive

Reinsurer

Fronting insurer issues policies and arranges claims handling service.

Reinsurance cessions to captive; captive retains risk at agreed level such as a quota share amount.

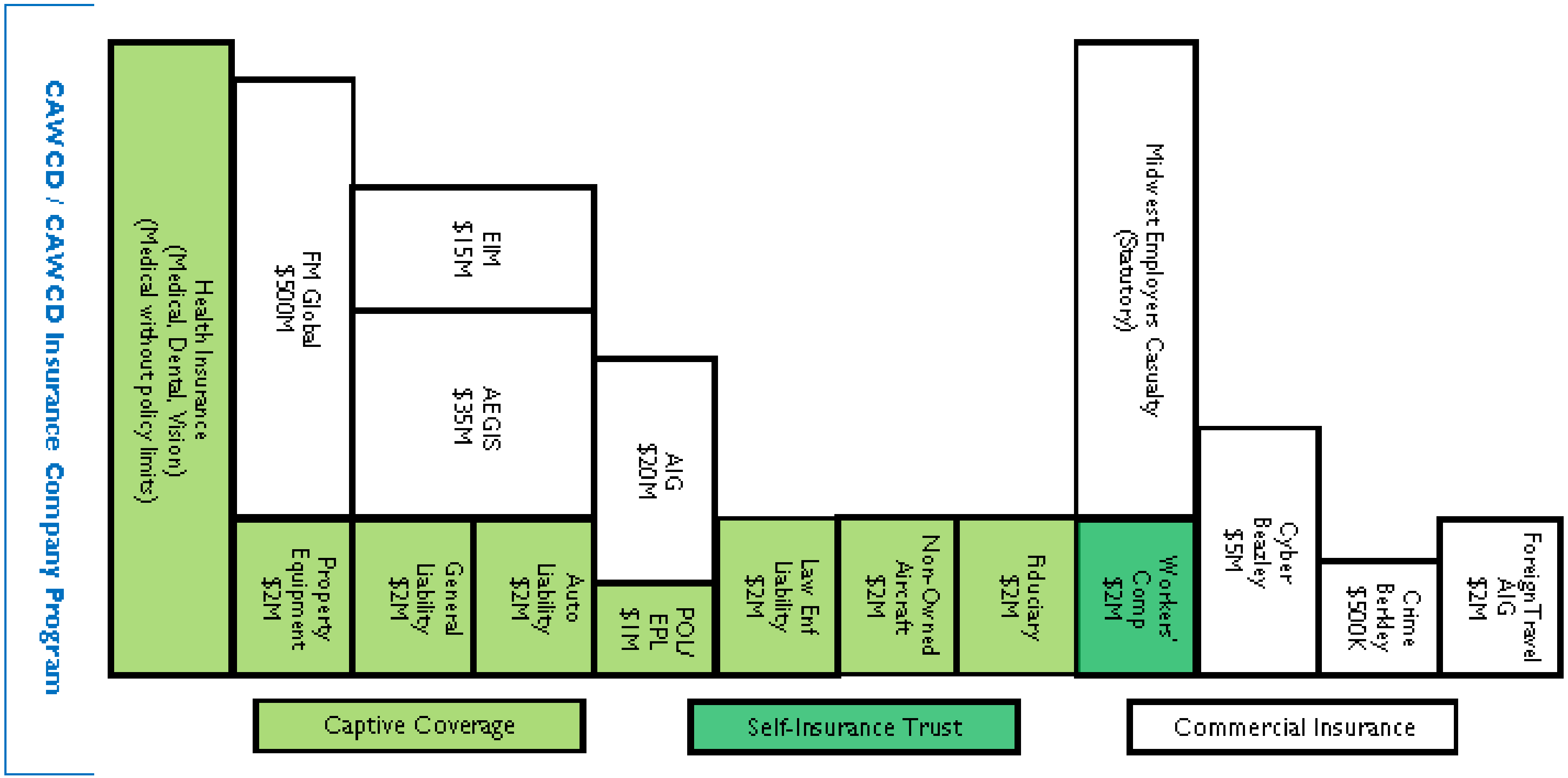
Captive retrocedes risk in excess of its desired retention.

Coverage can be reinsured on a funds withheld basis so that the client does not have to post cash collateral/LOC or tie up its credit facility.

CAWCD Program Structure

The District purchases excess insurance instead of the Captive using reinsurance.

The Captive includes a deductible/reimbursement policy that follows the overlying policies.



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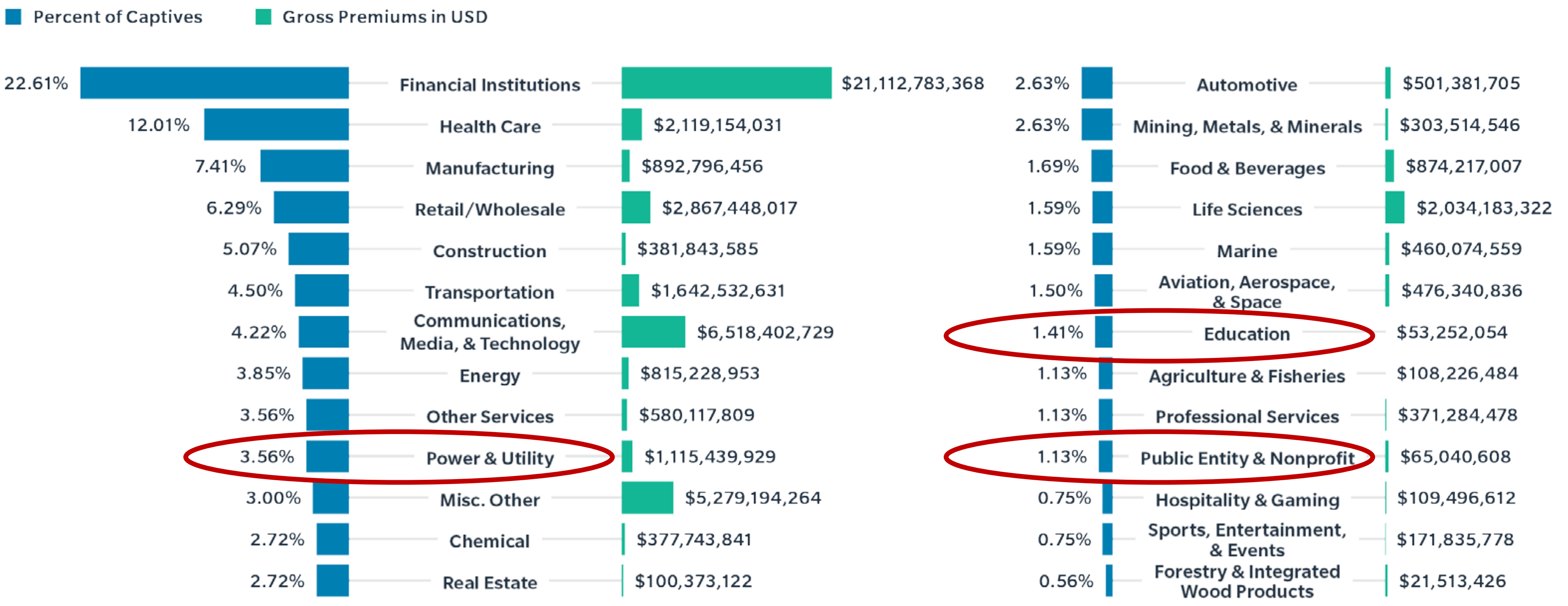
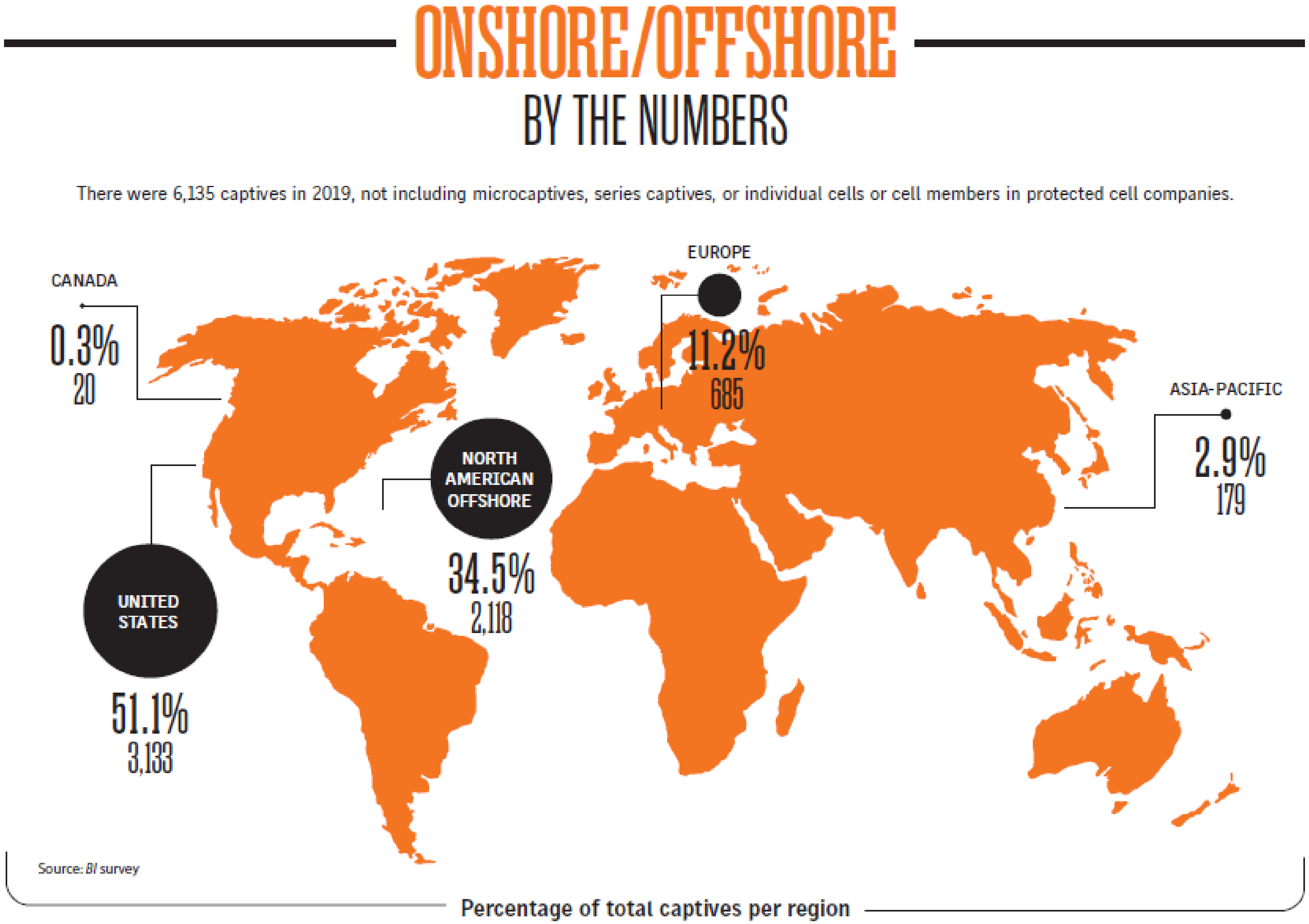
Are Public Entities Using Captives?

Financial institutions continue to dominate in number of captives, but captive use has expanded across industries.



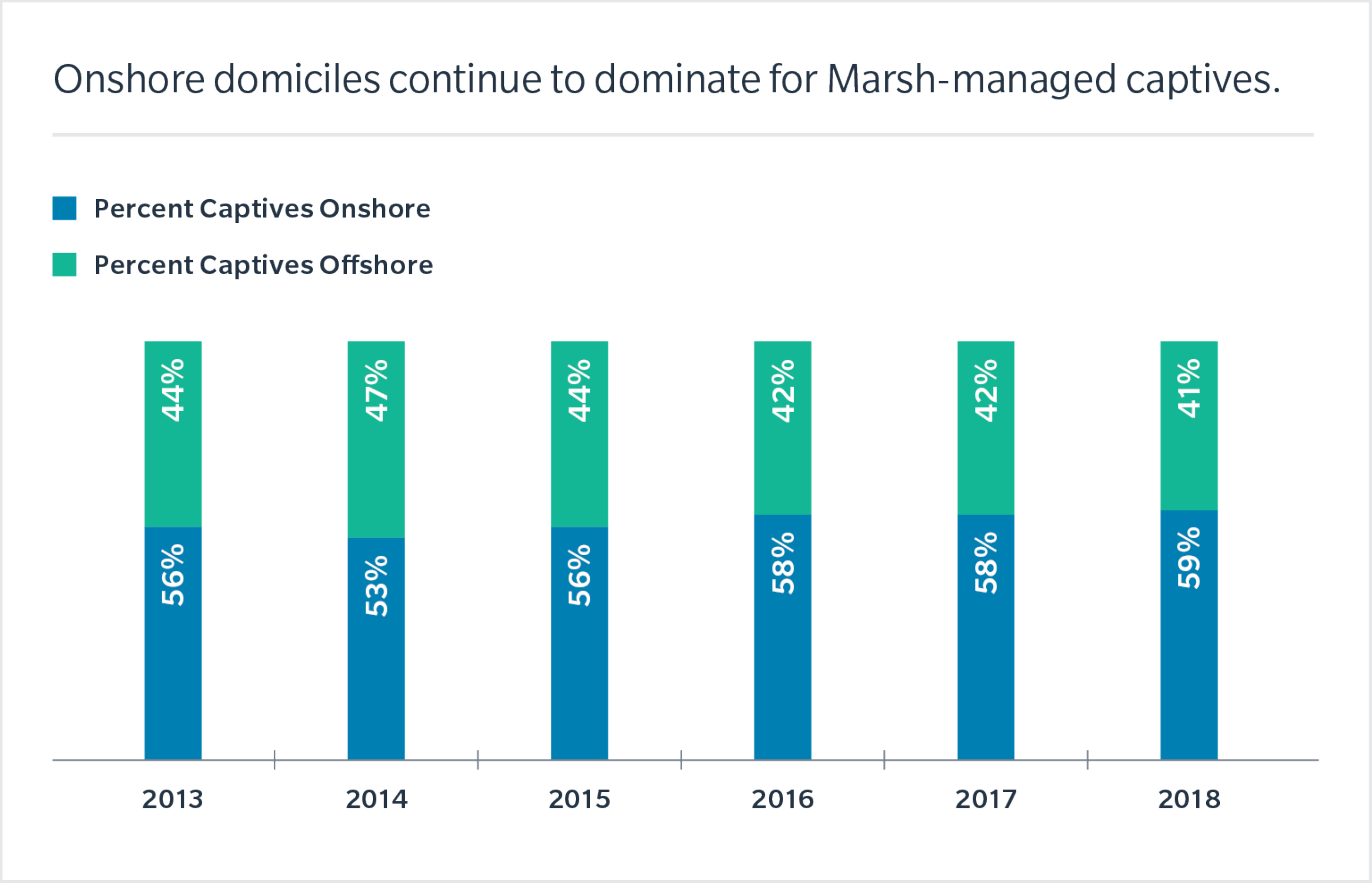
Where Are Captives Being Set Up?



Source: Business Insurance, 2019 Captive Managers & Domiciles, Rankings + Directory: 8. and governmental websites.

Where Are Captives Being Set Up?

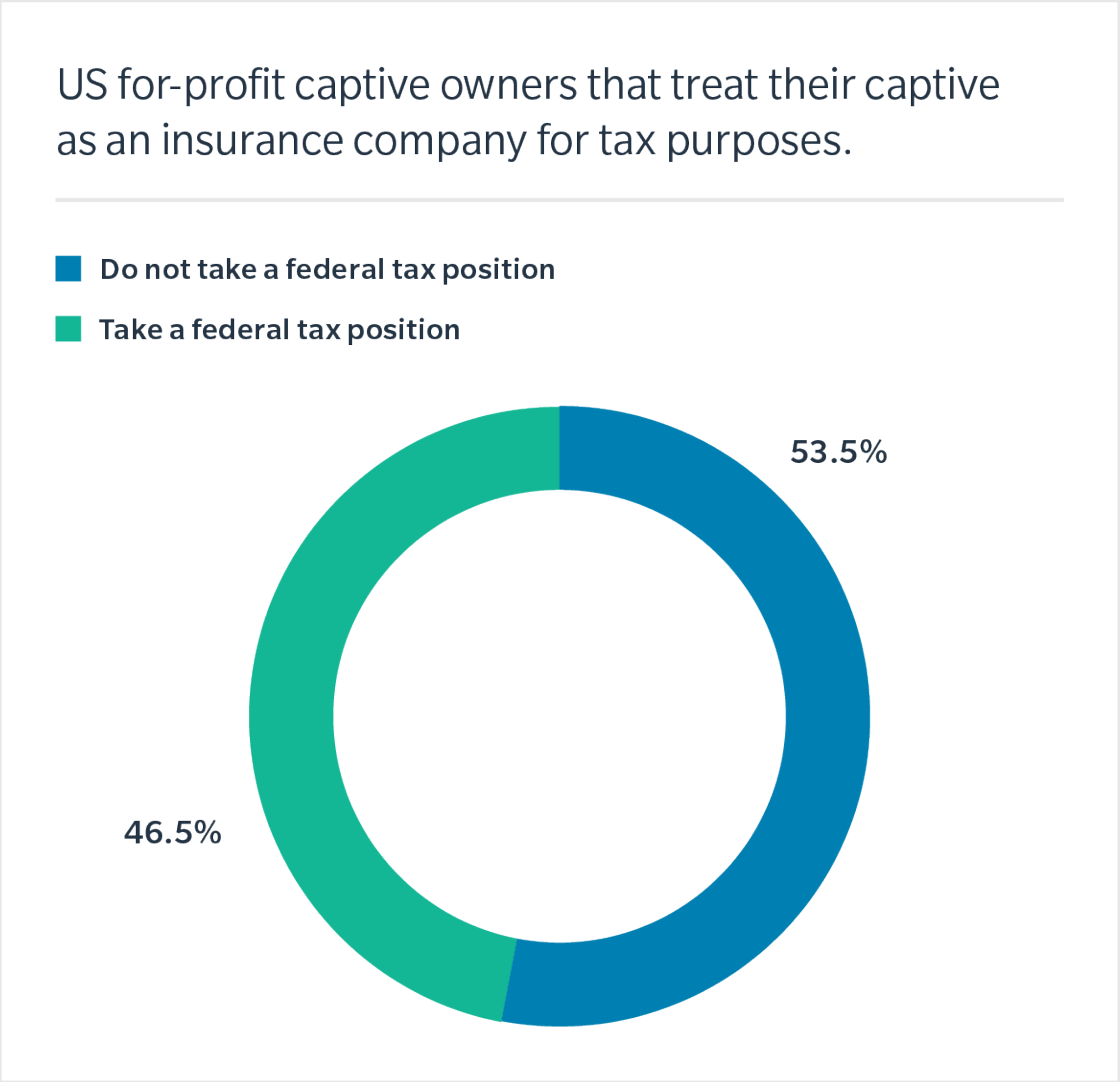
Even though there are numerous captive domiciles around the world, a majority of Marsh-managed captives opt for onshore domiciles.



Tax Benefits

While captives can offer tax efficiencies under specific circumstances, only 39% of Marsh-managed captives viewed tax benefits as a key value driver.

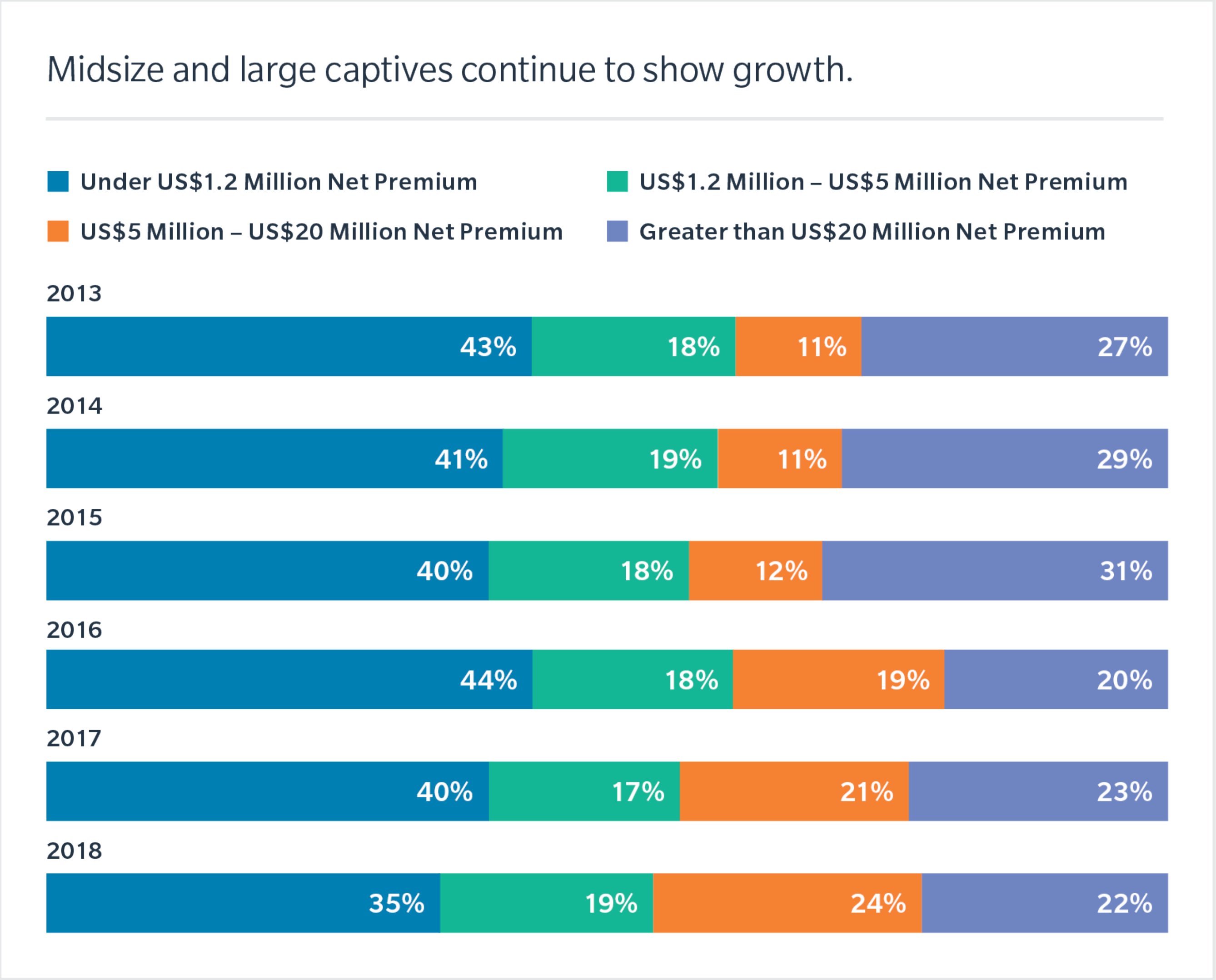
In 2018, less than half (46.5%) of all US companies owning captives treated their captives as an insurance company for federal income tax purposes.



Captive Size Trends

Captive growth in 2018 mainly occurred among entities with US$1.2 million to US$20 million in net premiums, corresponding to midsize and large captives.

Over the past five years, large captives — with US$5 million to US$20 million in net premiums — grew by 87%.



What Can be Written in a Captive?

Retained Risks:
- Property Ded. (AOP & DIC)
- Casualty Ded. (GL, AL, WC)
- FinPro Ded. (D&O, EPLI, Cyber)
- Supply Chain Ded.
- Business Interruption W.P.
- Construction Defect
- Warranties

Policy Exclusions / Sublimits:
- Mold / Asbestos / Lead
- High Hazard Cat (EQ / Flood / Wind)
- Professional Liability

Reinsurance Access:
- Medical Stop Loss
- Property Tower Participation
- Integrated Risk Programs
- Insurance Linked Securities

Third Party Risks:
- Extended Warranties
- Voluntary Employee Benefits
- Tenant Liability
- Subcontractor Default
- DIC Policies

Uninsured Risks:
- Wage and Hour Liability
- Trade Credit / Tenant Default
- Intellectual Property
- Event Cancellation
- Medical Stop Loss
- Key Person Life
- Contractual Liability
- Legal Defense Expenses
- Terrorism / NCBR / Active Shooter
- Auto Physical Damage

Parametric Risks:
- Weather derivatives

Benefits Of A Captive

Benefits Of A Captive

Companies establish captive insurance vehicles for at least one of the following reasons:

Cost:

Reduce reliance on third parties and capture costs and profits leaked to insurers. In addition, there may be corporate tax benefit in earning profit in a captive insurance vehicle located in a lower tax jurisdiction.

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Benefits Of A Captive

Companies establish captive insurance vehicles for at least one of the following reasons:

Capacity:

A captive insurance vehicle can access international reinsurers and specialty insurers directly, which can introduce new capacity, greater competition, and better pricing for insured risks.

Benefits Of A Captive

Companies establish captive insurance vehicles for at least one of the following reasons:

Control:

As the primary insurer a captive insurance vehicle can tailor its cover (policy language), manage claims and direct subsequent reinsurance to ensure that the group enjoys the widest possible coverage, at the best price, in a fully transparent manner.

Benefits Of A Captive

Companies establish captive insurance vehicles for at least one of the following reasons:

Compliance:

A captive insurance vehicle provides a legal basis for subsidiaries to pool retained risk across borders and different tax systems. The accounting, tax, and legal treatment is well known and understood. Conversely, transactions with less formalized risk retention vehicles (RRVs) may be subject to greater scrutiny by various regulators and tax authorities around the world.

Benefits Of A Captive

Companies establish captive insurance vehicles for at least one of the following reasons:

Cover:

A captive insurance company can issue proof of insurance (cover note or an insurance policy) to comply with contractual obligations. The group may prefer to retain certain risks that it is contractually obliged to insure. For example, professional liability insurance for customers or leased property insurance to a landlord. A captive insurance vehicle can evidence insurance and capture premium that would be otherwise leaked to third parties.

Benefits Of A Captive

Companies establish captive insurance vehicles for at least one of the following reasons:

Commercial:

A captive insurance vehicle can participate in third-party insurances offered to customers, vendors, or other related parties, such as customer warranty insurance or sub-contractors under an Owner Controlled Insurance Program (OCIP).

Feasibility Process

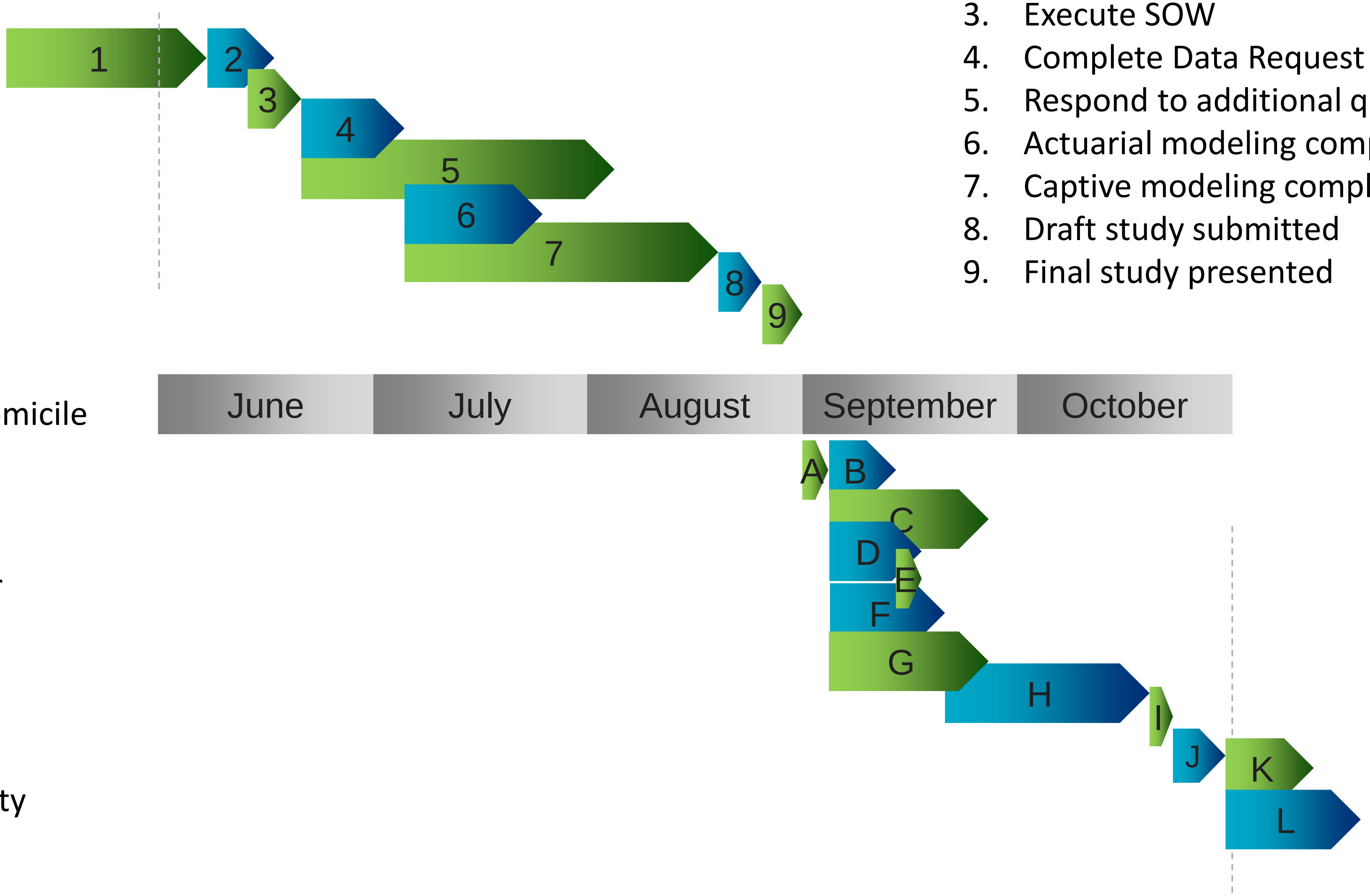
Steps 2 – 4 take approximately 45 to 60 days after data request is completed.

STEPS	1 Educational Discussion to Identify Captive Opportunities	2 Objectives Defined	3 Feasibility and Modeling	4 Feasibility Report	5 Implementation of Strategic Objectives
KEY ACTIVITIES	• Conduct a basic company diagnostic. • Provide a general overview on captives. • Identify potential opportunities.	• Define captive feasibility study objectives/scope including potential opportunities.	• Review potential opportunities and coverages. • Analyze operational and financial advantages. • Outline captive structures. • Review domiciles. • Address key cost, tax, and operational considerations. • Hold additional discussions with client as needed.	• Summarize conclusions of feasibility study and provide recommendations. • Outline implementation plan of recommended strategies.	• Revise implementation plan. • Meet with captive regulators. • Draft business plan and pro formas. • Prepare and submit regulatory application.
DELIVERABLES	• Relevant brochures and educational information.	• Engagement letter outlining key objectives	• Data request. • Timeline and action plan.	• Feasibility report. • Implementation plan.	• Business plan and pro formas. • Regulatory application.

How Long to Set Up?

Feasibility Process

1. Captive Education
2. Determine Scope of Study
3. Execute SOW
4. Complete Data Request
5. Respond to additional questions
6. Actuarial modeling completed
7. Captive modeling completed
8. Draft study submitted
9. Final study presented



Implementation Process

A. Decide to proceed / Select domicile
B. Select service providers
C. Establish corporate entity
D. Develop business plan
E. Initial meeting with Regulator
F. Submit Application
G. Submit final documentation
H. Receive approval letter
I. Capitalize captive
J. Receive Certificate of Authority
K. Hold organizational meeting
L. Issue policies

How Much To Setup?

Estimated Costs** (USD thousands)	Initial	Annual
Feasibility Study/ Management Fee	35	60 - 80
Formation Fee	25	–
Actuarial Fee	25	25
CPA Audit Fee	–	30
Legal Fee	10	5
Premium Taxes	–	Varies
License Fees	5	0.3
Miscellaneous	10	10
Total	**110**	**130.3 - 150.3**

**The captive costs above are estimates and not inclusive of all costs related to establishing and operating the captive.

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Discussion Time

Photo credit: Source Unknown (Bing)