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2024 Conference & Trade Show

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What Exactly Are These 'Captives' I Hear About and Should I Be Recommending Them to My Insured?

10:15 AM - 11:15 AM

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1 CEU

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Captives

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What is Captive Insurance?

- **Alternative** to traditional insurance
- Involves establishing an **actual insurance company**

to provide specific types of commercial insurance to its

owner or participants who **benefit financially** from the underwriting profits

- A form of **self-insuranc**e but a bit more sophisticated
- Captive insurer sets rates, bills premium and either handles claims or uses a claim administrator
- **Can reinsure potential losses**
- Conduct business in parent company’s home state and must **comply with state insurance regulations and statutes**
- In the same way that businesses incorporate in Delaware for the simplicity and tax advantages, captives often domicile offshore for tax and other benefits.
- In the US, **Vermont is the leading domicile for captive insurers**

Captives are “nonadmitted,” only licensed in its domicile, not in the state or country of the insureds that are buying insurance from the captive and offer **no protection for their insureds from state guaranty funds**.

A Captive is either…

Owned and controlled by parties unrelated to insured

- **Sponsors:** contribute statutory (core) capital
  - Insurers, reinsurers, agents, brokers, and consultants)
- **Participants:** Invest risk capital but have either little or no ownership
  - Insureds

100 percent owned, directly or indirectly, by the insureds Wholly owned subsidiaries of parent company

- **Only risks of related companies** (parent, affiliates and controlled unaffiliated businesses)

TYPES

Pure Captive

- AKA Single Parent Captive
- Insure risks of their parent, affiliate, or controlled unaffiliated business
- Can insure third-party risk *at discretion of management*
- Typically, annual premium of at least $1.5 million is required to achieve desired cost benefit

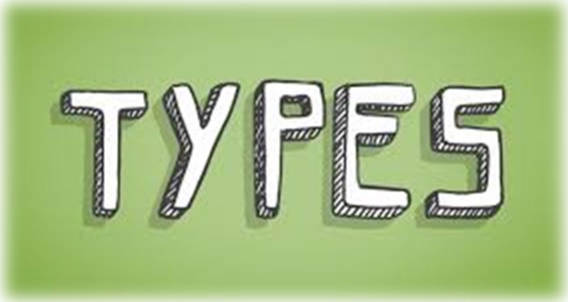
Association Captive

- Jointly owned or sponsored by **group of companies/persons in same trade, service or industry**.(*profit or non-profit*) **for the benefit of its members**
  - Heterogeneous group is a group of insureds from entirely different industry
  - ***Most US domiciles require group captives to be pure, to not write any unrelated business***
- AKA multiple parent or joint venture captives
- Make sense when sufficient member interest and commitment exists
  - Or when needed insurance is not readily available or affordable in marketplace.
- **Members (Shareholders)**
  - Own and are insured by group captive (Pure)
  - Typically on captive's board and actively participate in decisions
  - Are required to make a direct capital or surplus contribution
- **Sponsoring Association**
  - May contribute all required capital
  - Or no legal and nominal financial, and only endorse program
- **Shares risk with other insureds at a predetermined later - Insured capital at risk based on performance of group as a whole.**
- Consist mainly of workers compensation, auto, and general liability
- Typically, annual premium of $500,000 is required to make participation financially attractive

TYPES

Sponsored Captives

- Aka Multiple Parent Captive
- **Not formed by its insureds**
  - Participants do not have ownership or control of the facility
  - Insured is participant and puts its own capital at risk.
  - **Insured's risk capital is typically only exposed to risk of its own underwriting performance**
- Can be structured to maintain legally separate underwriting accounts
- Insured uses *Capitive Facility* for management of its own risks - control over structure of their insurance program may be given to Participant
  - ➢ **Agency Captive**
    - Owned by one or more **licensed insurance agencies or brokers** to reinsure preferred client risks
  - ➢ **Rent-a-Captive**
    - **Companies within same industry not large enough to form own captive**
    - Generally no sharing of risk among the participants - owner charges participants a fee
    - If captive proves successful, underwriting profits plus investment income may be returned to participants
    - Higher fixed costs and minimal entry barrier expenses (legal, licensing)
    - Typically, annual premium of $250,000 is required to achieve desired cost benefit
  - ➢ **Segregated Portfolio or Protected Cell Captives (SPC or PCC)**
    - Generally have a sponsor who provides start-up capital and expertise.
    - **Participants are legally separated and protected**
    - Assets in one participant account may not be used to pay liabilities in another, *unless respective participants have entered into agreement to do so.*
    - Require more initial capital than other captive types.
    - Beneficial where participant could not afford or justify forming independent captive



Risk Retention Groups (RRGs)

- A type of Pure Captive
- Insureds must be owners, and all owners must be insureds
- insureds put their own capital at risk to form group-owned risk pooling company
- Operate as traditional insurance with higher operating costs, so not as beneficial

Special Purpose Vehicles (SPV)

- **specialized captive reinsurance companies**
- used to create alternative finance sources to cede portions of risk to 3rd parties, usually investors in the capital markets

BUT WHY?

- Structured and managed correctly, captive insurance company participation can be **a very good financial investment**
  - retain an interest in premiums and earnings on premiums
  - more control over the claims process
  - have an ownership interest in the insurance company you pay premiums to.

Pool resources secures more favorable insurance terms:

- ➢ Spreads risk, lowering insurance costs for each participant
- ➢ Group members actively manage their risks, resulting in lower claims and more predictable insurance costs
- ➢ Members know precisely where their premiums go and have a say in how funds are used
- ➢ Enables purchase of insurance directly from reinsurance companies at significant cost savings

Insurance Agencies
- Increase client service levels
- Retain clients over very long periods of time
- tool to use in successfully developing niche markets
- Potential to created captives in which they share ownership and profits with their client-insureds

Commercial Insurers
- Expand their products or clients
  - **Fronting insurers**
    - Commercial insurance company ("fronting company")
      - Licensed in state(s) where a risk from captive is located
      - Comply with insurance regulations (auto & WC) that require coverage written by admitted insurer
      - Insurance policy is issued on fronting company's paper
      - Provide access to services such as claims handling and risk control
      - Provide excess risk transfer capacity, from the fronting insurer in a cost-effective manner.
    - Captive
      - Through fronting agreement the risk is transferred to the captive at some level
      - Acts as reinsurer rather than direct insurer
- Sponsors
- Reinsurers

Insureds
- Are the beneficiaries of underwriting profit and investment income
- Save if they design *tax favored risk coverage* not available in commercial marketplace
- Can achieves larger planning objectives

Captive Managers
- Usually located in domicile where captive is licensed
- Responsible for regulatory compliance and keeping captives' books.
- Typically, independently owned or are part of a larger organization
  - Financial services company, insurer, or broker

Historically

- Companies with at least $100,000 in traditional insurance premiums
- Over $10,000,000 in revenue
- At least 50 employees.

And captives now… **Its more affordable due to**

- **legal innovations**
- **declining capital requirements and operating costs**

- Some group, cell and series LLC. programs make financial sense for much smaller companies and professional practices

- Smaller captives often take advantage of *US Internal Revenue Code section 831 B* which allows qualified **small captive insurance companies to be exempt from federal income tax on operating income**

Commercial Insurance versus Captive

	Commercial Insurance	Captive
Investment Income	• Ability to offset underwriting losses with investment income • Lowering rates will produce enough additional investment income to offset underwriting losses • Underwrite risk below expected loss costs and use it to engage in rate cutting to retain or gain market share.	• Premium accumulated in investment account pending payment of losses with earnings accruing to the captive. • Rarely adopt aggressive investment strategies • Rarely has large enough surplus to allow it to underwrite risk below expected loss costs
Market cycles	• Dramatically affected by price competition • hard and soft market swings	• Affected only to extent reliant on commercial insurance above the captive retention
Unbundling	• Underwriting expenses and profit included in rates (as much as 40%) • Costs to file rates and forms membership in rating agencies (ISO) • Paid by all insureds whether or not they actually receive any claims or loss control services • Premium includes 3-5% for premium taxes (regulatory assessments and fees) and Assessments for guaranty funds (WC)	• High administrative expense for Captive Manager • Lower other underwriting expenses by billing fees for services separately as needed • Reduced premium results in reduced taxes paid on premium • No residual market assessments
Reinsurance Costs		• Allows the insured direct access to reinsurance markets • May be some decrease in underwriting expense if excess coverage from alien insurers is purchased as reinsurance rather than as direct insurance.
Fronting Insurance Costs	• Retail rates	• wholesale premium rates • In some cases, risks that are uninsurable in commercial market can be insured in captive market

Self Insurance versus Captive

Self-insurance and deductible plans have to show access to funds to pay losses incurred for statutorily required coverages such as workers compensation.

Collateral posted to comply with state's financial responsibility and self-insurance laws, lowers organizations capital

The **most significant cost reduction** may be achieved if captive program is relieved of financial responsibility law to provide evidence of its ability to pay losses before a loss occurs.

The **captive manager** is responsible for the captive's regulatory filings.

A captive insurance company needs to perform many of the same functions as a commercial insurer.

How these functions are handled is relevant in **making sure the captive can legitimately be treated as a real insurance company and not a self-insurance mechanism.**

- Typically decision about whether to accept or decline a risk remains with the commercial insurance or reinsurance companies that are part of the captive program.
- The captive delegates its underwriting responsibilities to specialists in whichever line of risk it is writing.

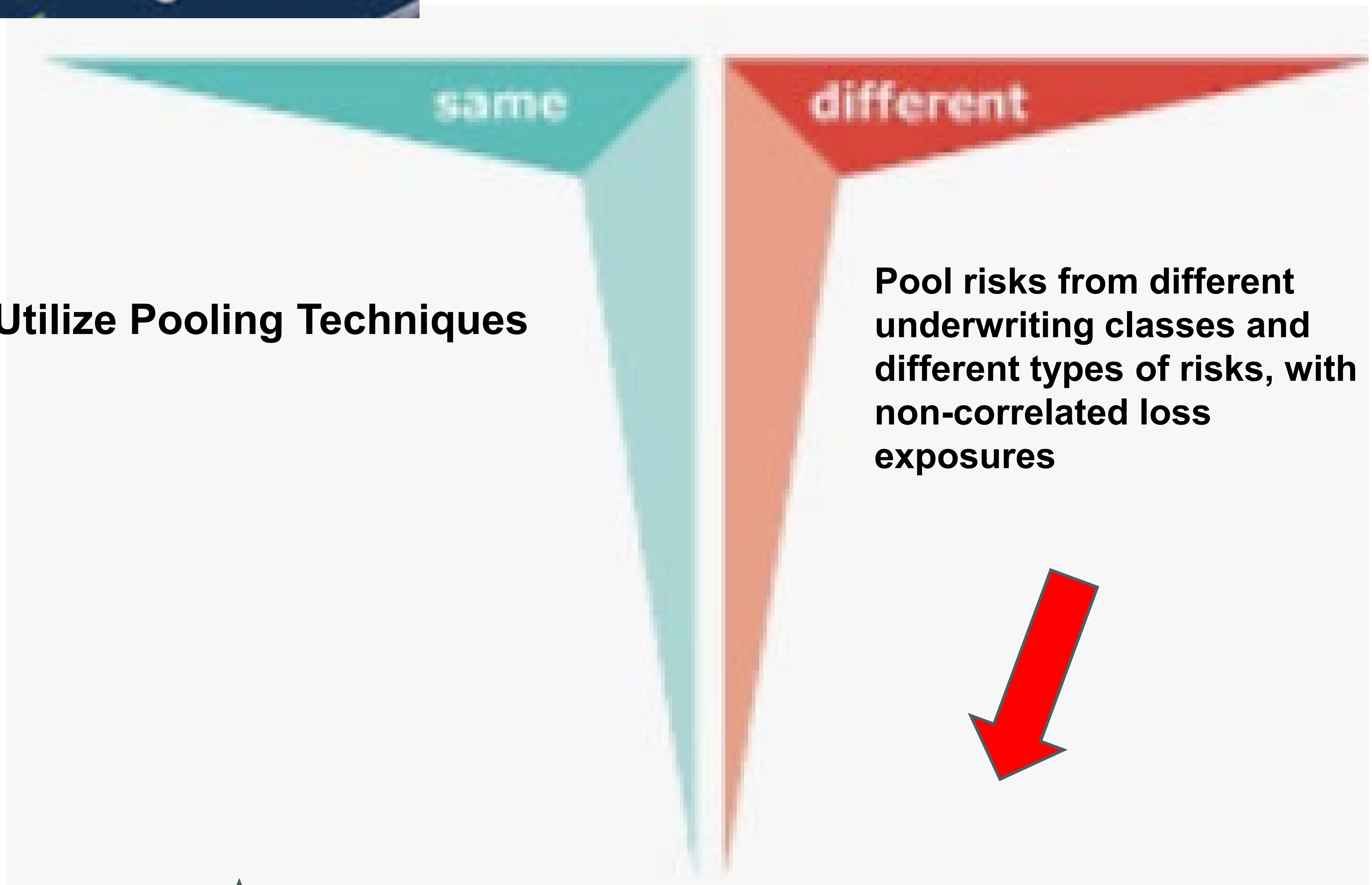
Traditional methods of risk transfer

- Based on providing insurance where there is a large population of risks to be pooled from different sources
- Underwriting profit expectations are based on there being a number of insureds with similar risks.
- must earn underwriting profits to survive
- **Though any one insured risk may not produce an underwriting profit, the profit for the group as a whole can be statistically calculated.**

Captive

- Have different operating objectives.
- May choose to underwrite risk not because it is profitable to do so but because it **serves some other purpose or provides some financial or other benefit to its shareholders or insureds**

important distinction between captive and non-captive insurance

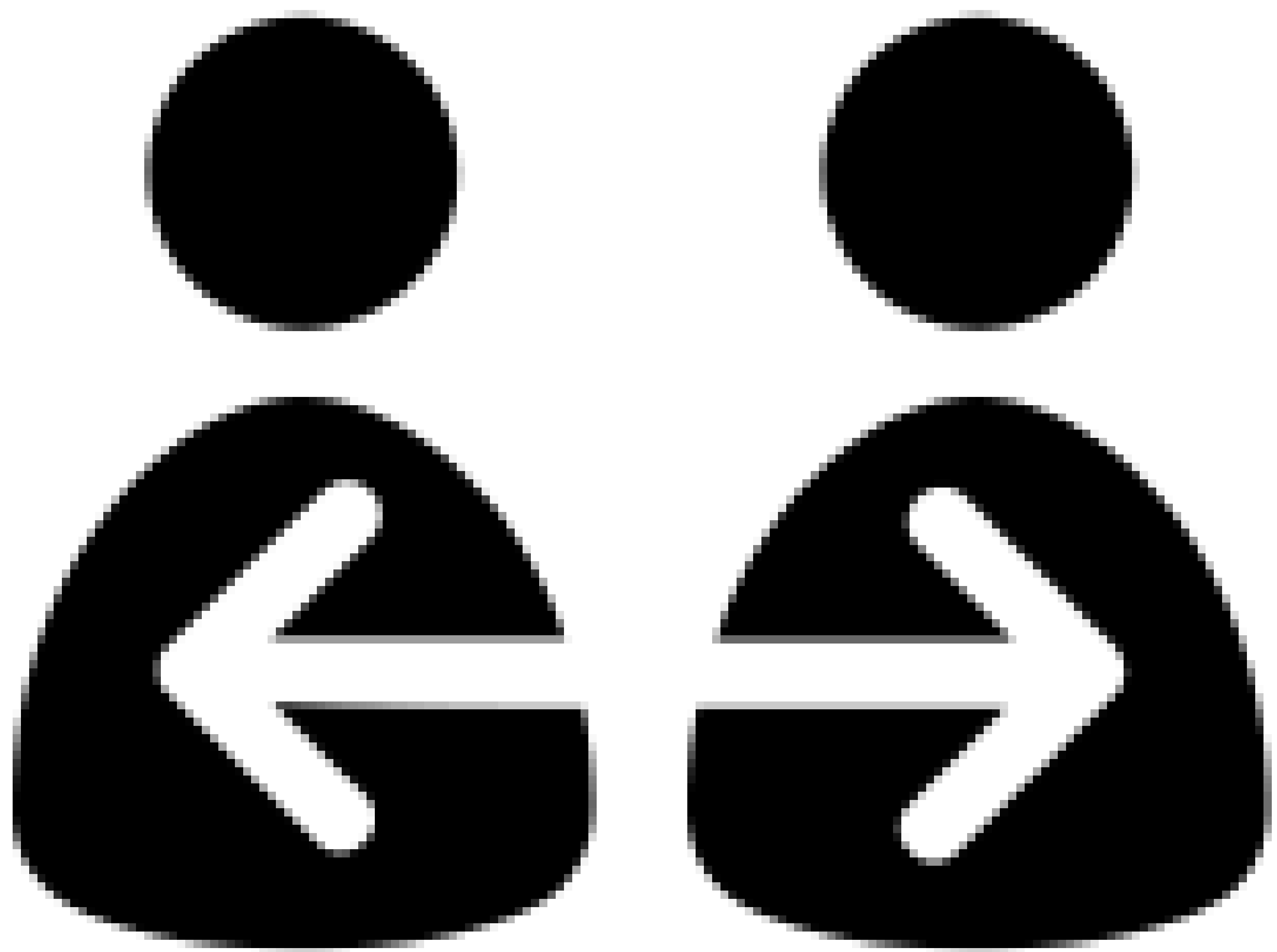


Utilize Pooling Techniques

Pool risks from different underwriting classes and different types of risks, with non-correlated loss exposures

★ **Remember as a participant, insured shares in underwriting profits as compensation for sharing in risk of loss.**

Though the general principle is that captive owners are insureds, a **captive is a separate legal entity** and must be seen to operate as such.



This means that it **must maintaining an arms-length relationship between the captive and its insureds.**