ARM – 56
Risk Financing

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Chapter 7

Captive Insurance

Captive Insurance

Educational Objectives

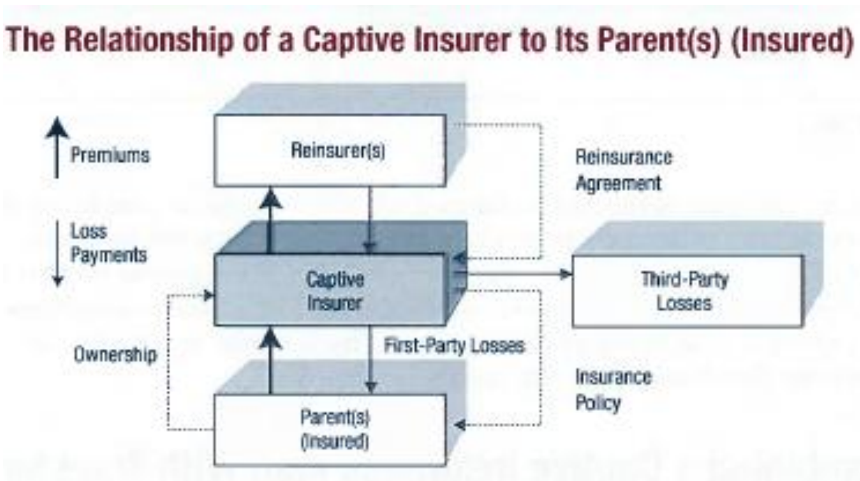
After learning the content of this assignment, you should be able to:

- Describe the purpose and characteristics of captive insurance plans.
- Describe the types of captive insurance plans available.
- Describe the advantages and disadvantages of using a captive insurance plan.
- Describe the following considerations for forming and operating a captive insurance plan:
  - Conducting a feasibility study
  - Operating as a reinsurer or a direct writing captive insurer
  - Selecting lines of business
  - Setting premium arrangement
  - Determining captive domicile

Captive Insurance Plans

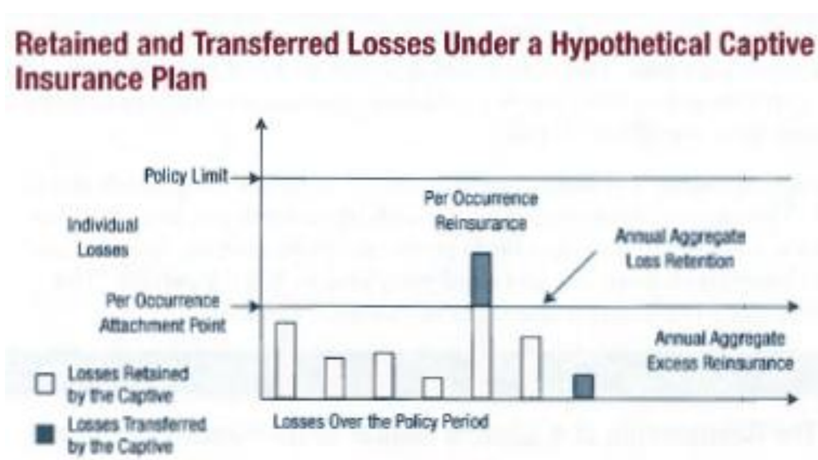
- Definition
  - A subsidiary formed to insure the loss exposures of its parent company (companies) and affiliates whose primary purpose usually is to reduce the parent's cost of risk.
- Relationship of captive to parent is similar to any other insurer
  - Collects premium, issues policies, pays losses
- Usually is very large companies and involves captive purchasing reinsurance

Captive Insurance Plans



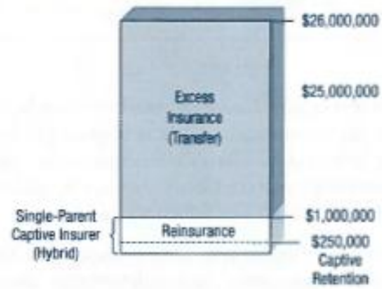
5

Captive Insurance Plans



6

Captive Insurance Plan Combined With Excess Insurance

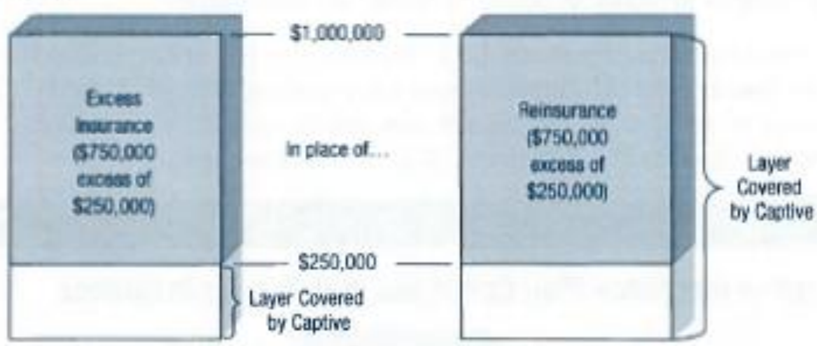


The organization purchases excess insurance on a guaranteed-cost basis with a limit of $25 million per occurrence to sit directly above the $1 million per occurrence layer of loss covered by the captive insurer. Therefore, the total limit of insurance available to the organization per occurrence is $26 million.

The organization, in effect, retains the first $250,000 per occurrence because its captive insurer retains $250,000 per occurrence, net of reinsurance. The portion of each covered loss that exceeds $250,000 per occurrence up to the policy limit of $1 million per occurrence is transferred to reinsurers through the organization's captive insurer.

7

Purchasing Excess Insurance Instead of Reinsuring a Captive Insurer



General Characteristics of a Common Captive Insurance Plan

Retention/ Transfer	Severity of Losses	Funded/ Unfunded	Administrative Requirements
Hybrid (usually)	Low to medium	Usually funded	High

8

Type of Captive Insurance Plans

- Single Parent
- Group Captive
- Risk Retention Group
- Agency Captive
- Rent-a-Captive
- Protected Cell Captive

Single Parent or Pure Captive

- Definition
  - A captive insurer owned by one company that insures all or part of the loss exposures of that company.
    - Considered to be a hybrid plan
    - Loss retained by captive are in effect, retained by parent
- Usually requires at least $2 million in premium to be viable option

Group and Association Captives

- Group Captive
  - Owned by a group of companies, usually operating similar businesses, rather than a single parent
- Association Captive
  - A group captive that is sponsored by an association.
    - Must be a member of the association to buy from captive
- Depending on design can be transfer plan or act as a hybrid plan

11

Risk Retention Group (RRG)

- Definition
  - A group captive formed under the US Liability Risk Retention Act of 1986 to provide liability coverage (except personal insurance, employer liability, and workers' comp).
- Rules and Benefits
  - All owners must be from same industry and must be insured by RRG; and all insureds must be owners
  - Main benefit is that it only needs to be licensed in one state to provide coverage in any other state
    - Saves money
    - Some states are litigating regulatory oversight

12

Other Captives

- Agency Captive
  - Captive owned by insurance agents or brokers rather than by the organizations insured.
    - Formed in response to hard markets
    - Allows agents and brokers to assume some risk and generate underwriting and investment income

Other Captives

- Rent-a-Captive
  - Arrangement in which organization rents capital from a captive insurer, to which it pays premium and receives reimbursement for its losses
    - Insureds keep own premium and loss accounts, no sharing of losses
    - Allows for quick set up with captive without tying up capital

- Protected Cell Company
  - Similar to rent-a-captive , but protects a participants assets and surplus in the event other participants become insolvent

Advantages of Captive

- Reducing the cost of risk
- Benefiting from cash flow
- Obtaining insurance not otherwise available
- Having direct access to reinsurers
- Negotiating with insurers
- Centralizing loss retention
- Obtaining potential cash flow advantages on income taxes
- Controlling losses
- Obtaining rate equity

15

Advantages of a Captive

- Reducing the cost of risk
  - Reduces underwriting expenses, overhead costs, and allows for investment income from premium
- Benefitting from cash flow
  - Investment income earned due to payout patterns and benefits of retrospective programs
- Obtaining insurance not otherwise available
  - Environmental, professional liability and TRIA coverages
- Direct access to reinsurers

16

Advantages of a Captive

- Direct access to reinsurers
  - Capture ceding commissions and better terms
- Negotiating with Insurers
  - Captive allows options and bargaining power
- Centralizing Loss Retention
  - Subsidiaries and franchise would buy insurance from captive

17

Advantages of a Captive

- Obtaining Potential Cash Flow Advantages on Income Taxes
  - Premiums considered a business expense
- Controlling Losses
  - Loss control programs reap immediate savings to captive and/or parent organization
- Obtaining Rate Equity
  - Better able to predict losses and therefore benefit from accurate loss history

18

Disadvantages of Captive

- Capital Requirements and Start-up Costs
  - Must capitalize new corporation in order to pay losses
  - Can be in the millions to capitalize for large programs
- Sensitivity to losses
  - Especially true in early years
- Pressure from Parent Company Management
  - Captive arms-length, but may be pressured to have low premiums
- Premium Taxes and Residual Market Loadings
  - Must pay fees and taxes as regulated by location where domiciled.

Operating a Captive
Conducting a Feasibility Study

- An income statement and balance sheet
- At least five years of projected pro forma financial results
- An accounting of the effects of all types of taxation (or an explanation of why a certain tax does not apply)
- At least one scenario that portrays worse than expected financial results and that demonstrates management has considered the possibility of financial impairment
- A detailed explanation of each assumption, such as expected loss ratio, interest rates, and year-to-year growth rates
- A model showing the minimum number of participants, premiums, and capital

Operating a Captive
Reinsurer or Direct Writing

- Fronting Company
  - A licensed insurer that issues an insurance policy (paper) and reinsures the loss exposures back to a captive insurer owned by the insured organization
    - Provides paper to show coverage
    - Can provide claims handling and loss control services for a fee
  - Fronting fee can range from 8% to more than 30% depending on size and maturity of captive

- Direct Writing Captive
  - Issues policies directly to parent, does not use fronting company
  - May result in complying with non-admitted insurer regs

21

Operating a Captive
Other considerations

- Selecting Lines of Business
  - WC, GL, PL, EPL

- Setting Premiums
  - Guaranteed cost, retrospective, etc..

- Determining Domicile
  - Foreign or domestic domicile; regulations and tax considerations

- Dedicated Management Resources of Parent

- Administering the Plan

- Insuring Third Party Business

- Financial Accounting Issues

22

Operating a Captive
Domicile Issues

When evaluating a domicile for a captive insurer, the organization should consider these factors:

- Minimum premium requirements
- Minimum capitalization
- Solvency requirements
- Incorporation and registration expenses
- Local taxes
- Types of insurance that can be written
- General regulatory environment
- Investment restrictions
- Ease and reliability of communications and travel to and from the domicile
- Political stability
- Support infrastructure in terms of captive managers, claim administrators, bankers, accountants, lawyers, actuaries, and other services

23

Requirements for Forming a Captive Insurer in Utah

Utah is an onshore domicile for many captive insurers. Some of the requirements for establishing and operating a captive insurer in Utah are these:

Requirement	Details
Capital	Ranges from \$100,000 to \$500,000 by type of captive, although additional capital may be required (satisfied by cash or an irrevocable letter of credit).
Surplus	Ranges from \$150,000 to \$1,000,000 by type of captive (satisfied by cash or an irrevocable letter of credit).
Premium tax	\$5,000 annual fee.
Examination	All captives must submit to examination by the commissioner every 1-3 years.
Annual reporting	A captive insurer must submit an annual report of its financial condition using generally accepted accounting principles unless the commissioner approves otherwise.
Reinsurance	Captive insurers may take credit for reserves on risks ceded to reinsurers if the captive complies with requirements of the Utah Insurance Code.
Local office	A captive insurer must maintain its principal place of business and hold at least one board of directors meeting each year in Utah. At least one board member must be a resident of the state. Captive insurance companies must appoint a resident agent for service of process.

24