Captive Insurance – Fundamentals and Development Issues

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Nick Dove, R&Q Quest Management Services LLC
Hugh Rosenbaum, Towers Watson
Gary Bowers, Johnson Lambert
John Hernick, Xcel Energy
Captives – Critical numbers

Retention (risk tolerance)
Capital required
Critical premium and loss amounts
Comparison to next best alternative
The context: risk retention

PRE -  

Insurance  Captives  Financing  Non-insurance

POST -
Number of Captives: Continual growth?

Source: Best’s, Business Insurance
What are Captives?

To regulators (and the NAIC!)
  To the IRS
  To the DOL (Benefits)
  To managers and service providers
    and...their owners!
    ...or members
Why captives? The Key Reasons

- Cost reduction
- Access to reinsurance
- Investment income
- Administrative tool
1. Cost Reduction

“I want to reduce insurance costs.”

Obvious example:

“Low loss ratio?”

<table>
<thead>
<tr>
<th>Losses incurred</th>
<th>Premiums retained</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 30%</td>
<td></td>
</tr>
</tbody>
</table>

Retentions: The group could take higher retentions, but the individual members or business units can’t.
Cost Reduction: How?

Reduce high rates
- Eliminate nonessential services
- Eliminate pooling charges
- Avoid charges for guarantee funds
- Reduce administration charges
- Reduce or eliminate commissions
- Reduce profit margins
- Control of claims
2. Reinsurance

“I want access to reinsurance capacity.”

Example:
A large healthcare group found reinsurers were

more willing to reinsure a captive

...than excess insurers willing to insure above a SI trust

Reinsurance! Where? How much?
2. Access to Reinsurance: Specific and aggregate limits

- Per Claim
- Annual Aggregate

$10,000K
$1,000K
$100K
2. Reinsurance

*Useful to know: Rate On Line (RoL) : (Premium/limit)*

- **Low** 1%-5% RoL
- **Average (expected)** 10%
- **High** 20%-25% and up

(Examples)
3. Investment Income

When interest rates are high enough, loss reserves for lines with longer payout patterns generate extra income.
3. Investment Income (2)

1,000,000 of loss reserves, paid out over seven years produces investment income

3% 104,000
4% 147,000
5% 181,000
7% 267,000
4. Administrative Tool

Group retention: $1,000,000

Divisional retention: $500,000

Member or operating unit retention: $100,000

Funding in captive
There might be economies of scale in a group captive

All the previous reasons plus ...

The value of shared retentions, shared aggregates, shared services

Example: Risk Retention Groups

-an “escape from fronting”
4. Administrative Tool (cont.)

**Example:** WC High Deductible Funding

**Step 1:** $500,000–$1,000,000 high deductible, small premium

**Step 2:** Captive issues reimbursement policy, direct. Large premium

**Step 3:** Insurer pays claims, charges owner. Captive reimburses owner
Example: For Estate Planning

Privately-held firms use captive insurance vehicles for succession planning
So do promoters of “831(b) captives”
Use of cells particularly favorable
Types of Captives
Single Owner/Group Captives

Single Owner – Direct

- Shareholder
- CAPTIVE
- REINSURERS

Subsidiaries
Or Members
Central RM
Or Administrator

Group Captive – Direct

- A
- B
- C
- D
- E

GROUP CAPTIVE
REINSURERS
Protected Cell Company Structure

Owner

PCC Facility

Management company

Cell 1

Several S/H

Cell 2

Single S/H

Cell 3
Protected Cells – How they work

- Surplus (Dividend)
- Reinsurance
- Cell Retention
- Capital (or guarantees)
Advanced Cell Structure

Joint Venture Cell

Individual Cells
### Cell or Captive?

<table>
<thead>
<tr>
<th></th>
<th>Captive</th>
<th>Cell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full control</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Capital</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Regulatory fees</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Management fees</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Auditor’s fees</td>
<td>✓</td>
<td>✗ (maybe)</td>
</tr>
<tr>
<td>Directors’ fees</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Indirect costs</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Liquidator’s fees</td>
<td>✓</td>
<td>✗</td>
</tr>
</tbody>
</table>
Other Types of “Captives”

Risk Retention Groups

Reciprocals

PORCs and agency-owned captives

SPVs and XXX entities

Mini or micro (“831-b”) captives

Pools of captives
Employee Benefit Captives 2013

Number of Employee Benefit Captives 2013

- 3 Retiree Medical
- 28 US Life & LTD
- 65 International Risk Benefits

Estimated Premiums Paid To Employee Benefit Captives in 2013

- $500 million
- $425 million
- $255 million
- $20 million

- $3 Billion

Pensions | US Stop Loss Medical | International Risk Benefits | US Life & LTD | Retiree Medical

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Start-up Captives: The Timeline

Idea

Feasibility Study

Management Approval

Captive Manager visit

Business Plan

Fronting Negotiation

Implementation
Feasibility (refeasibility)

Why do one
Who should do it?
For whom – audience?
Does it (still) make sense?

To find out....
# Feasibility: Key Factors

<table>
<thead>
<tr>
<th>Amount</th>
<th>Confidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claim amounts</td>
<td>✓</td>
</tr>
<tr>
<td>Premiums</td>
<td>✓</td>
</tr>
<tr>
<td>Capital</td>
<td>✓</td>
</tr>
<tr>
<td>Fronting, Reinsurance</td>
<td></td>
</tr>
<tr>
<td>Costs</td>
<td>✓</td>
</tr>
</tbody>
</table>
Feasibility: The Output

Reminder: What we listed at the beginning

Factors: (previous slide)

Most important: Does it work?
### Feasibility: The Numbers!

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Underwriting results</td>
<td>1,156,452</td>
<td>1,252,952</td>
<td>1,186,200</td>
<td>1,251,360</td>
<td>1,542,340</td>
<td>6,389,303</td>
</tr>
<tr>
<td>Investment Income</td>
<td>94,459</td>
<td>151,402</td>
<td>194,286</td>
<td>238,520</td>
<td>286,213</td>
<td>964,880</td>
</tr>
<tr>
<td>Captive net income</td>
<td>1,250,911</td>
<td>1,404,354</td>
<td>1,380,485</td>
<td>1,489,879</td>
<td>1,828,553</td>
<td>7,354,183</td>
</tr>
<tr>
<td>Income tax (if any)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>After-tax income</td>
<td>1,250,911</td>
<td>1,404,354</td>
<td>1,380,485</td>
<td>1,489,879</td>
<td>1,828,553</td>
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Captives – The Big Issues

Fronting

Domicile and regulation

Captive management

....Tax factors
Fronting: 2014 Problem #1

- Insureds
- Fronter
- Captive
- Security
- Reins.
- Claims
Fronting Issues

Availability

Collateral – security – guarantees – investments

Cost of fronting

Insurance/risk transfer

Services

Emerging: Security of captive’s reinsurers
Fronting Guarantees – 2014 Concerns

Funds transferred to a reinsurance captive
  Loss reserves, IBNR
  Premium reserves
  Schedule F penalties

Risk Gaps – must be guaranteed?
  Expected losses (>100%!)
  Aggregate maximum fronting exposure

Stacking of years
Closing out old years
Fronting Guarantees – Types

1. **Letters of credit** (cost, availability)

2. Reinsurance trusts (lower cost, but fronter reluctance)

3. “Other” including:
   - Collateral “enhancement”
   - Factoring plus trade credit (new)
Captives by Domicile/Number

<table>
<thead>
<tr>
<th>2012: the top eight (out of 70!)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bermuda</td>
</tr>
<tr>
<td>Vermont</td>
</tr>
<tr>
<td>Cayman</td>
</tr>
<tr>
<td>Guernsey</td>
</tr>
<tr>
<td>Anguilla</td>
</tr>
<tr>
<td>Utah</td>
</tr>
<tr>
<td>Barbados</td>
</tr>
<tr>
<td>Luxemborg</td>
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Top 10 = 2/3 of total. US domiciles =1/3 of all captives
Captive Domiciles

Onshore – offshore: the major factors in 2014

Perception

Regulation (..and FATCA)

Tax factors

... Costs
Regulation — Differences

Too much

Just Right

Too little
Tax Factors

Deductibility
- Must resemble "normal" insurance

Premium Taxes
- State
- Federal Excise
- Self-Procurement

Tax On
- Captive Income
- Shareholders
  - "Elections"

And...
- Offshore/onshore "non-profits"
- 831-b small ones
Taxation – Current Issues

831b structures: use and abuse

More intrusive activity
  Example: FATCA (more later)
  Other issues (Our expert has more)
Management Matters

Too much  Just Right  Too little
Captive Management: How It Works

- Investment Income
- Losses
- Dividends
- Expenses
- Investments
- Reinsurance
- Capital
- Premiums

Captive
Keys to Captive Financial Success

- The right rates (who sets them?)
- Low expenses (what expenses?)
- The right loss estimates (actuaries!)
- Reinsurance protection that works
- The right investments (by whom?)
- The right initial capital (how much?)
Two more Keys to Captive Success

Long-term dedication

Risk management (of the captive’s risks!)
Constant Conflicts

Low cost  Versus  Captive profits
Captive Endings

Refeasibility!
Novation, LPT, commutation
Redomiciliation, switch managers
Sale, merger
Liquidation
Our Time-tested Slogan ...

“Captive business is the best business”