New Risks (and Places) for Captive Insurers

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Panelists

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Discussion Points

- Basics of Captives
- Domicile Selection Considerations
- Captive Tax Overview
- New Risk Case Studies/Examples
- Q&A

Captive 101

Definition: A closely held insurance company that is owned and controlled primarily by its insureds

Characteristics

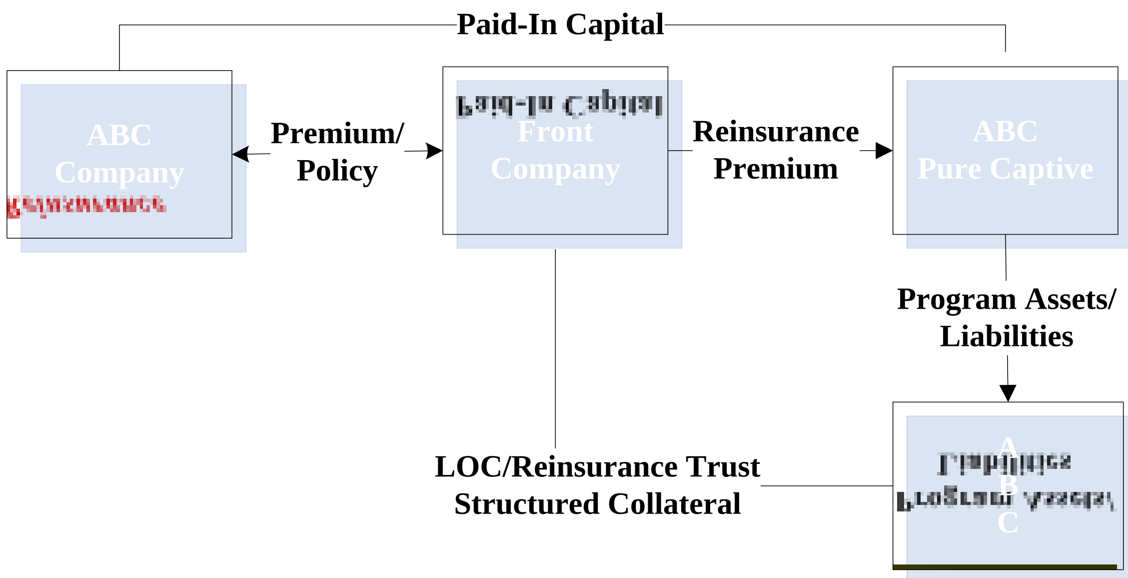
- A licensed insurance company
- Formed to insure or reinsure the risks of its owners or related parties of their choosing
- Regulated under special legislation regulating captives
- Located onshore or offshore
- Generally licensed in only one domicile

Types of Captives

- **Single Parent (Pure) Captive**
  - Wholly owned by one parent company
  - Formed primarily to insure or reinsure the risks of the corporate parent or unrelated parties of their choosing
- **Group Captive**
  - Owned by two or more companies, often times affiliated through a trade association or homogenous group of companies
  - Heterogeneous group captives are also available
  - Formed to insure or reinsure the risks of the group

Captive Risk Placement Structures

Reinsurance



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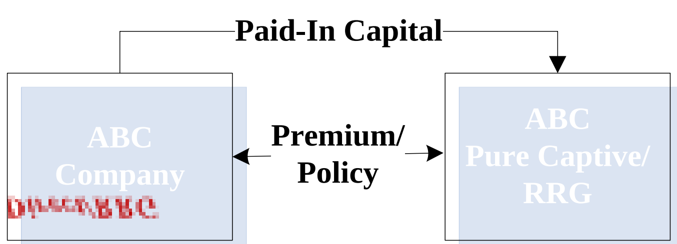


The Growing Role of Captives

- Captive usage have continued to grow over the past 30 years due to the desire by owners to increase the level of control over all facets of insurance including:
  - Ultimate cost and premium volatility;
  - Coverage
  - Claims Handling;
  - Accessing reinsurance to obtain additional limits or lower cost capacity
  - Serving as an internal “shock absorber” to stabilize earnings and the budges of operating entities
  - Prefunding uninsured/retained risks on a more tax efficient basis than pure self insurance

Key Domicile Decision Factors

Many states and jurisdictions want to be considered as domiciles but there are marked differences when you consider:

- Regulator Experience
- Regulator Accessibility
- Regulatory Flexibility – willingness to listen and work collaboratively
- Frictional Costs
- Capital Requirements
- Physical Accessibility
- Perception Issues

Captive Caveats

1. Captives require capital to begin underwriting - $120,000 - $250,000 base capital ***plus*** risk capital depending upon volatility of the underlying risk being insured.
2. Captives have annual operating costs of between $60,000 and $150,000 or higher for management, audit, actuarial certification and regulatory fees with ultimate cost a function of the underlying program complexity and domicile location.
3. Captives require a specific fact pattern to achieve insurance company tax treatment.

Insurance Company Tax Elections

- All insurance companies that want to be treated as such for tax purposes are taxed under:
  - Section 831 a (large captives) – taxed on reported profits – paid claims and loss reserves are deductible (on a discounted basis)
  - Section 831 b (small captives) – taxed on investment income – only but premiums are limited to $1.2 million per year
- Many captives choose not to be treated as insurance companies for tax purpose

Qualifying as an Insurer for Tax Purposes

- **Underwriting Risk Transfer** -10% - 15% chance of a 10% - 15% loss FASB 113 – moving towards 15% chance of 15% loss
- **Risk Shifting and Distribution** – transfer of risk from many insured to adequately capitalized insurer - law of large numbers
- **Commonly accepted notion of insurance** – captive must operate like "real" insurer – limited loan backs, retro provisions, payback provisions, timely payment of premium/claims, etc.
- **Non-tax business purpose**

All the above are true whether it's a small or large captive!

What works well – 831a captives

- Common large captive structures
  - Long tail casualty risks with IBNR reserves
  - Relatively predictable

- Common Types of Risks
  - Workers compensation
  - General and products liability
  - Auto Liability
  - Professional Liability

What works well – 831b captives

Common 831(b) structures

- Captive Insurer Used to Prefund Self Insured Risks (Known and Unknown)
- No Change to Risk Profile
- Budgeting for Volatile Self Insured Risks

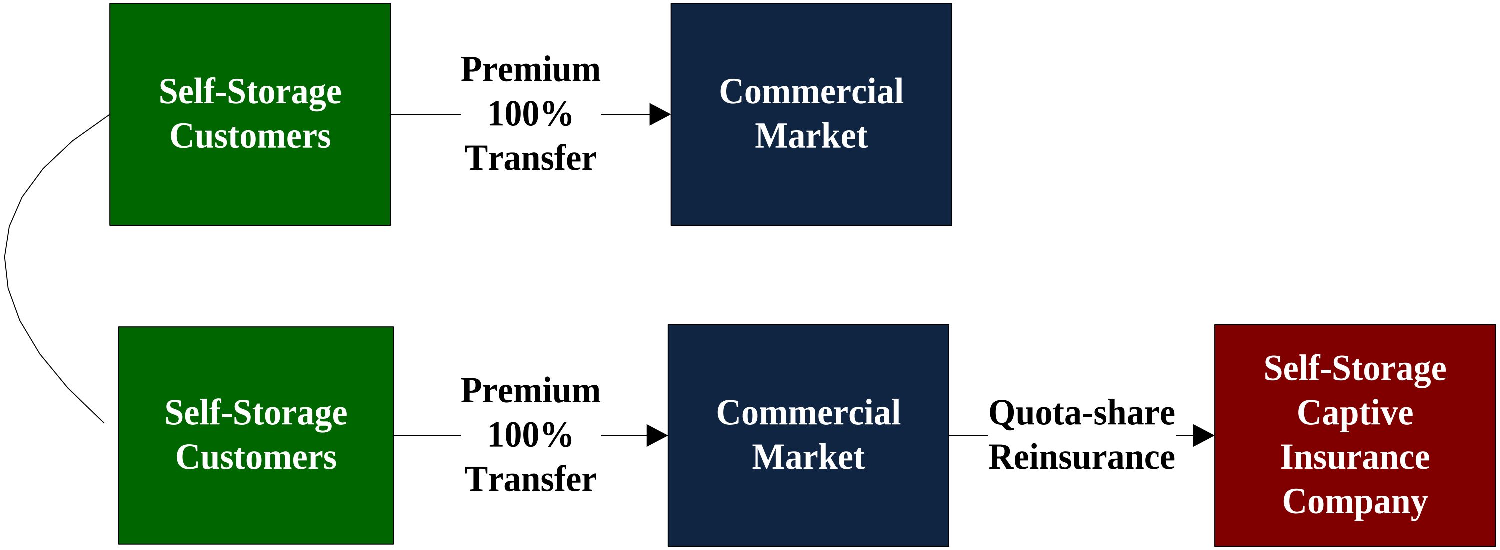
Common types of risks seen in 831(b) captives

- Weather risks: earthquake, windstorm, flood
- Difference in Limits / Difference in Conditions
- Property risk and related coverages (i.e. Mold)
- Cyber risk & excess liability
- Pollution liability & clean up

Captive Case Studies/Examples

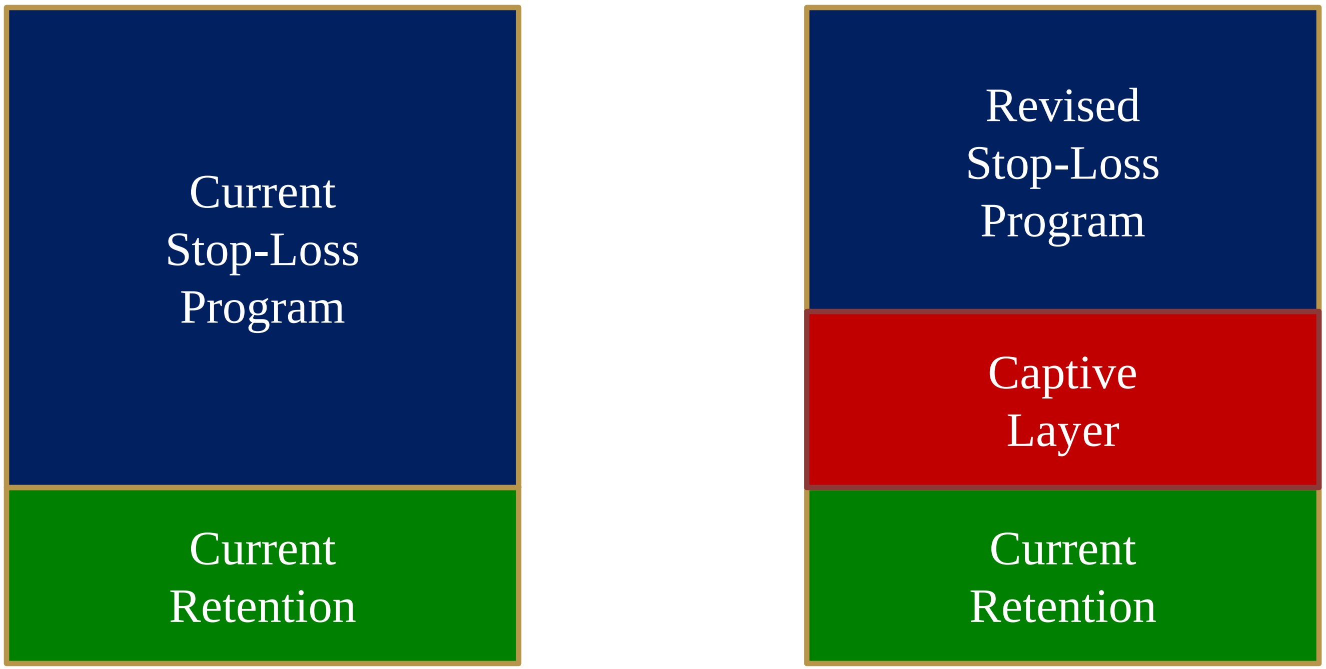
Self Storage Company - Profit Center Captive

- Self storage company marketed insurance to its customers
- Property coverage with loss ratio of less than 40%
- Inserted captive into transaction to share in the underwriting profit generated by their core business



Public Company - Medical Stop-Loss

- Expanded existing captive beyond P&C risks to underwrite a portion of medical stop loss retention
- Moved attachment point higher to gain efficiency
- Shifted protection from stop loss insurance to reinsurance for specific and aggregate protection – lower cost



Furniture Manufacturer/Importer

- Privately held organization that is a furniture manufacturer and importer with solid financials – cash flow, earnings, paying federal and state taxes
- Performed a coverage and claims review and identified risks that could be better managed via formalized pre-funding of future claims:
  - Contingent business Interruption from overseas suppliers
  - Cyber Risk,
  - Property in Transit and deductibles on owned and rented properties
  - Loss of Revenue due to the death, disability or unexpected departure of select employees
- Third party actuarial review priced risks at roughly $900K
- Formed onshore single parent captive ($250K capital)
- A percentage of captive owned by key employees as part of a long term incentive/retention plan

Demolition Contractor

- Privately held organization – Demolition, Dismantling & Asset Recovery Organization
- Complex legal structure consisting of in excess of sixteen legal entities
- Performed a detailed commercial coverage and self insured claims review and identified self insured risks that could be better managed via a captive insurer including:
  - Property DIC,
  - Excess Pollution & DIC,
  - Medical Stop Loss,
  - Cyber Risk Liability
  - Loss of Profit due to Safety Events
- Third party actuarial review priced risks at slightly over $1 Million
- Formed onshore single parent captive ($350K capital)

General Contractor

- Privately held organization – General Contractor
- Simple legal structure consisting of only four legal entities
- Client identified several self insured risks with history of manageable claims activity, but with large claims potential. Third party actuarial review priced risks at roughly $500k
- Captive reinsured general liability risks (Not WC) from Zurich on its Contractor Controlled Insurance Program (CCIP). Third party actuarial review priced risks at roughly $600k
- Formed onshore single parent captive ($350K capital)

Automobile Retailer

- Privately held organization – Retailer of various transportation vehicles
- Simple legal structure consisting of only one legal entity
- Captive insurance program structure focused on commercial insurance gaps and wraps
  - Business Interruption,
  - Defense cost,
  - Contractual liability,
  - Product recall and brand rehabilitation
- Third party actuarial review priced risks at roughly $500K
- Looked for a quick formation and a lower cost alternative due to smaller premium level
- Selected an offshore cell program

Mutual Fund Company

- Has significant cyber liability risk
- Purchases external coverage but has significant retentions and many aspects of risk are not covered
- Formed single parent captive and writes direct policy
- Form is a DIC/DIL written on an occurrence basis

Software Developer

- Company designs software used by the automotive industry – manufactures and dealers
- Clients want evidence of Tech E&O coverage
- Market price is expensive and client does not want to loose control of claims
- Implemented a captive program and found a fronting carrier
- No claims to date – building surplus and seeking reinsurance support

Homebuilder

- Privately held with strong financials, reputation and market presence in its geographic footprint.
- Historically had been spending significant premium for Home Owners extended warranties provided new homebuyers.
- Little to no claims activity under program for several years. Builders makes repairs in any case.
- Formed an 831b captive to reinsure HO Warranty company for major portion of risk to capture underwriting profits previously enjoyed by the warranty company.
- Captive provided collateral to the warranty company to guarantee payment.

Shipping Port

- Shipping port being privatized by country's government has previously had enjoyed a level of sovereign immunity due to government operation, but that was changing post privatization,
- Government providing funds for privatized entity to establish captive to cover any run off of old claims as well as prospective risk financing programs.
- Captive formed to cover large retentions under liability programs a well as "Turn Around Guarantee" coverage to attract traffic from competing ports.
- "Turn Around Guarantee" covered expenses a ship owner incurred as a result of a delay in unloading or loading of its vessel.

Industrial Cleaning Company

- Large Privately Held Industrial Cleaning Company formed a captive to cover retentions under its insurance programs such as:
  - Workers Compensation
  - Environmental Liability
  - Cyber liability
  - Contingent Business Income
- Due to the nature of its business and customers, customers can incur expenses and penalties, as well as lost production, if the plant does not pass FDA inspection on first pass.
- The insured developed a coverage for this exposure as a guarantee to the quality and speed of its services.

Implementation

- The process of underwriting new risks is the same for new or existing captives:
  - Identify candidates
  - Determine retention and limits structure
  - Calculate premium and volatility
  - Assess need for capital and availability or reinsurance
  - Evaluate tax impact and options
  - Submit to regulators for approval
  - Issue policy and begin underwriting

Sanitation Company

- Large Publicly Traded Sanitation firm was required to provide performance bonds to the many municipalities for which it provides sanitation services and operates landfills.

- Due to the number, frequency and cost of such bonds and the fact that the company indemnifies the surety anyway, it formed a well capitalized captive to provide reinsurance and collateral to the surety to capture underwriting profits.

Questions and Answers