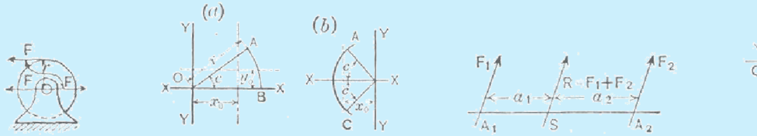
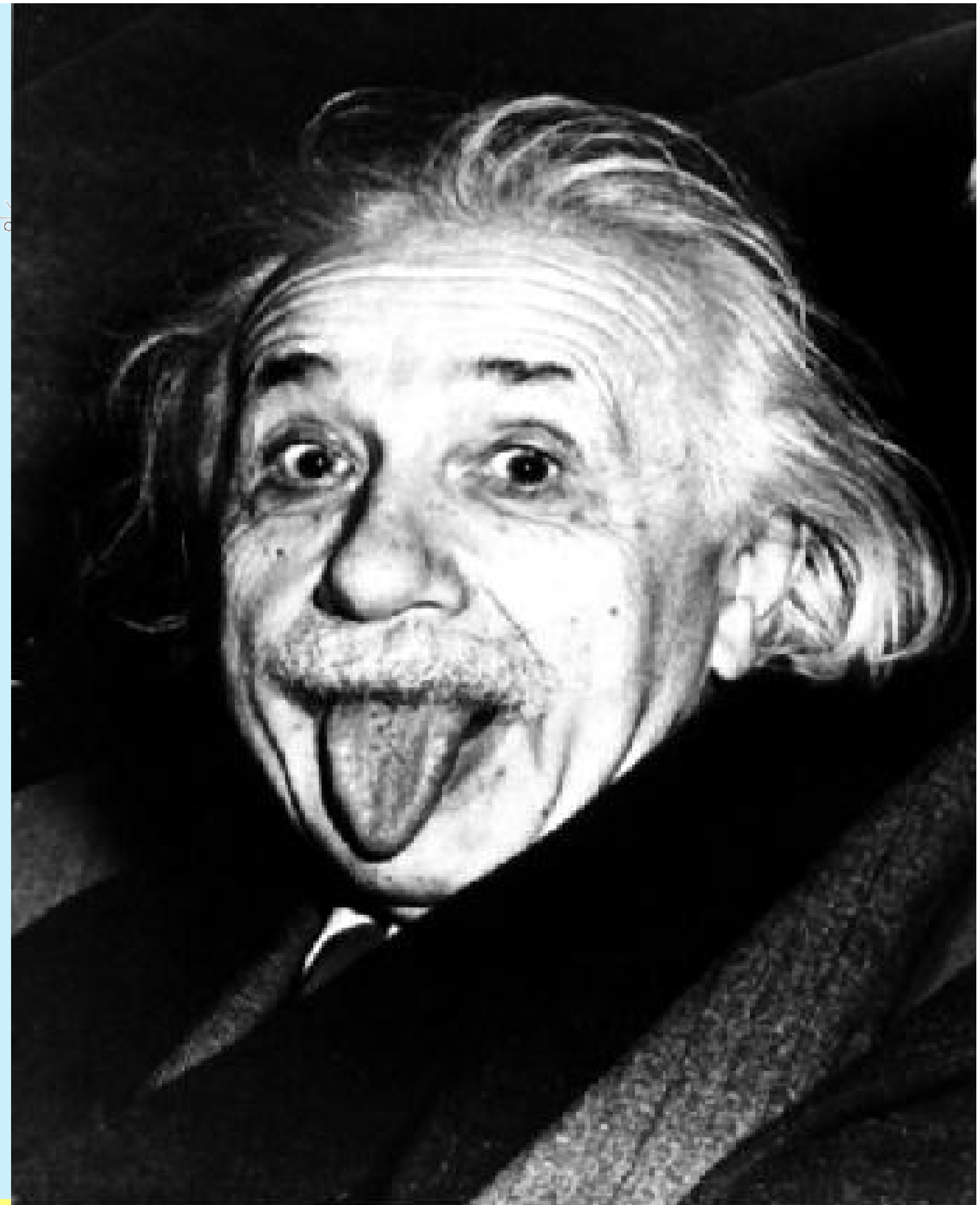


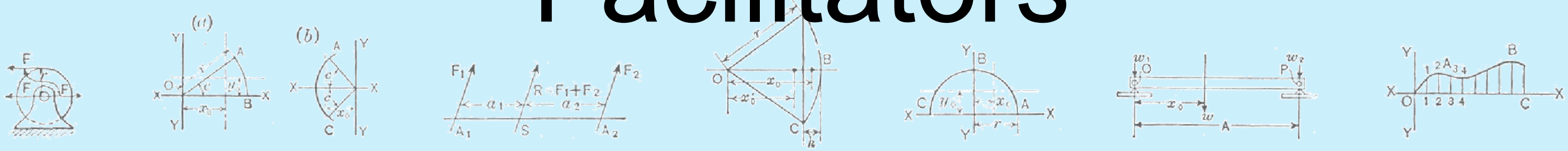
CAS 2012

An Introduction to Captives and Conducting the Annual Reserve Analysis

Is This Rocket Science?



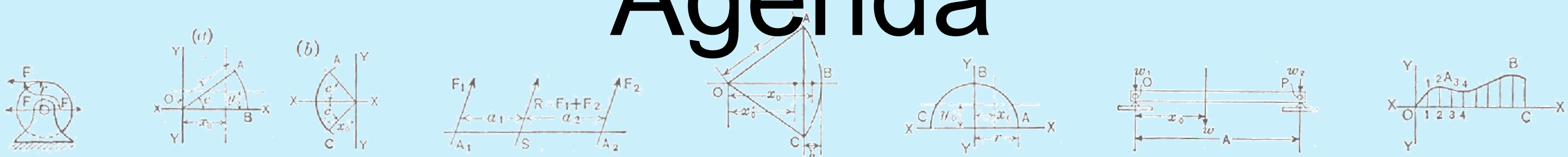
Facilitators



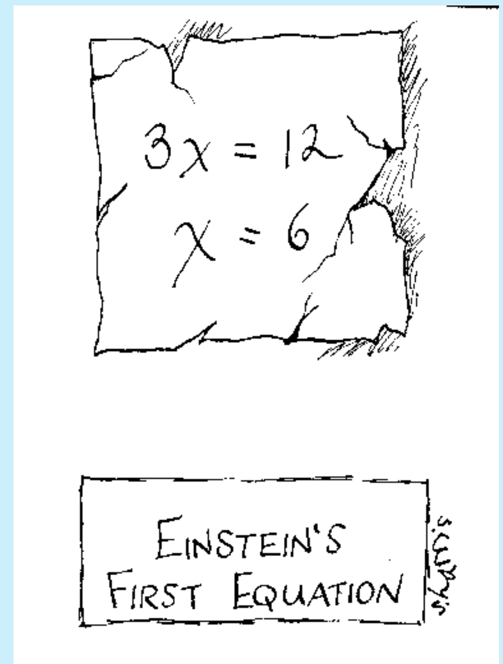
James Bulkowski, CPCU, ARM, ACI, AIS – Ernst & Young

Al Rhodes, ACAS, MAAA – SIGMA Actuarial Consulting Group, Inc.

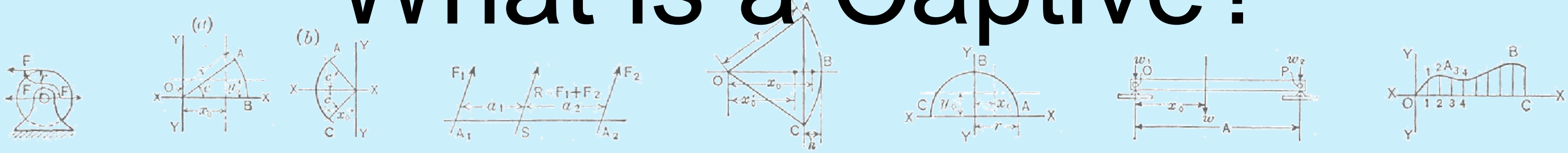
Agenda



- Captive Insurance Overview
  - What is a captive?
  - Formation reasons
  - Types of captive
  - Domicile summary
  - Tax
  - Capital
- Reserve Analysis
  - Typical reviews
  - Regulations
  - Feasibility
  - 831B and RRG
  - Captive manager
  - IRS



What is a Captive?

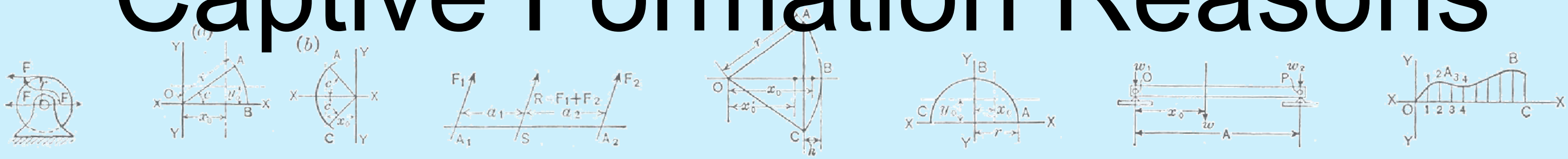


- Definition –
  - A captive is an insurance company that belongs to a corporation or group and underwrites or reinsurances primarily or exclusively the risks of firms belonging to that group. It can also underwrite unrelated business.

- It is also often:
  - A risk retention device
  - A vehicle for achieving an organization’s insurance, finance and management goals
  - Owned by shareholders whose primary business is not insurance
  - A direct insurer or a reinsurer
  - Tax efficient

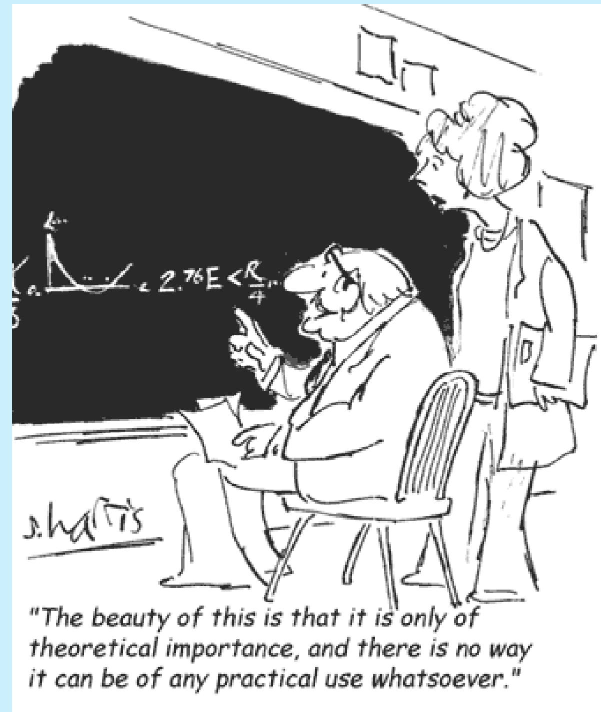
Note – Over 50% of the Fortune 1,500 have a captive

Captive Formation Reasons



Don't try to read them all!!!

Provide flexibility
Improved cash flow benefits
Provide evidence of insurance
State and local tax advantages
Analyze historical claim information
Ability to customize insurance programs
Direct access to the reinsurance markets
Opportunities for improved claim handling
Reduction of the cost of risk management
Provision of coverage otherwise unavailable
We will have the ability to control our destiny
We know our risks better than any underwriter
Provide management information across disciplines
Stabilization of pricing and risk management portfolio
Have an independent actuarial review of claim history
Federal tax advantages over large deductible programs
Create a potential profit center from a business expense
We do not want to be rated based on others and industry losses
Formalize the allocation of deductibles for self-insurance retention within a corporation
Off the shelf insurance programs do not always suit our company's strategy or circumstances
Reduce reliance on commercial insurance – less vulnerable to price fluctuations and market restrictions.



Types of Captives

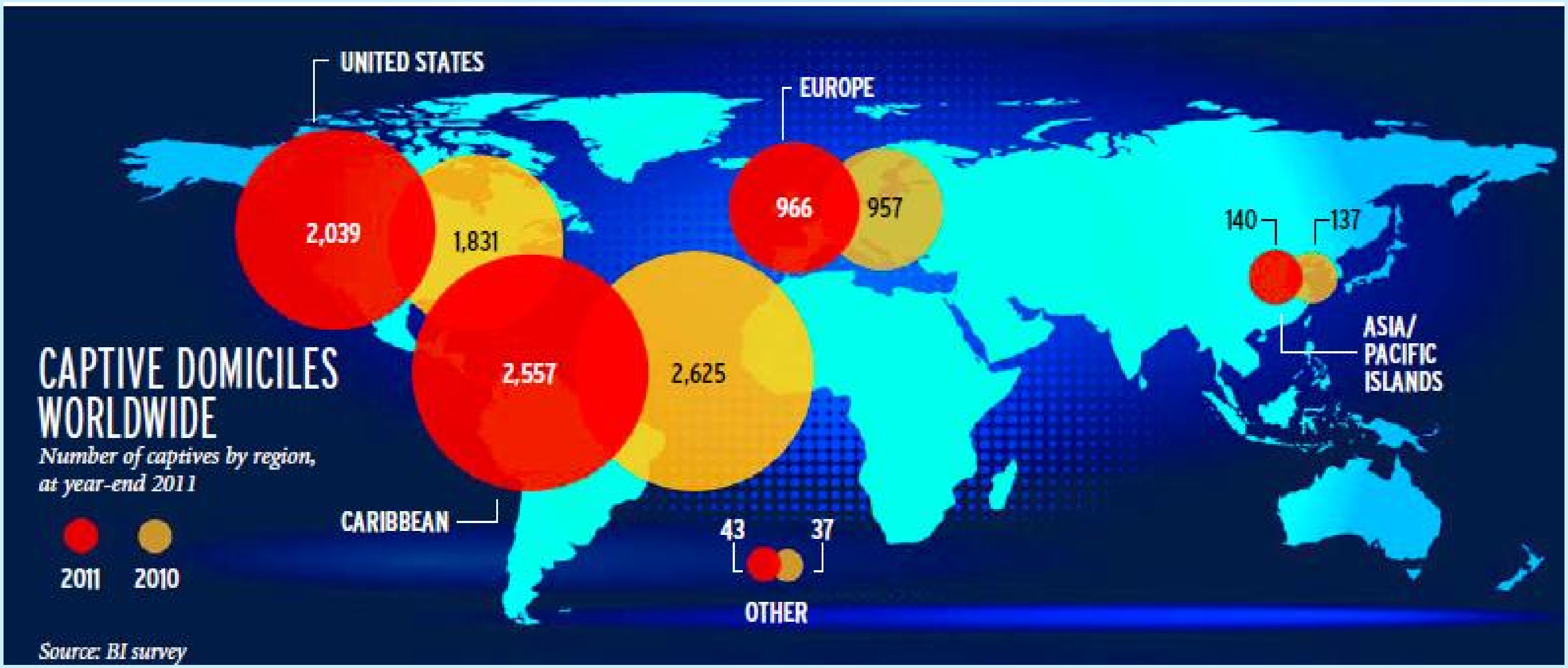
- Pure/single parent captives
- Rent-a-captive
- Association captives
- Group captives
- Risk retention group (RRGs)
- Agency
- Cell captives
- 831(b) – small captives

Types of Risk Typically Insured

(That often require a reserve calculation)

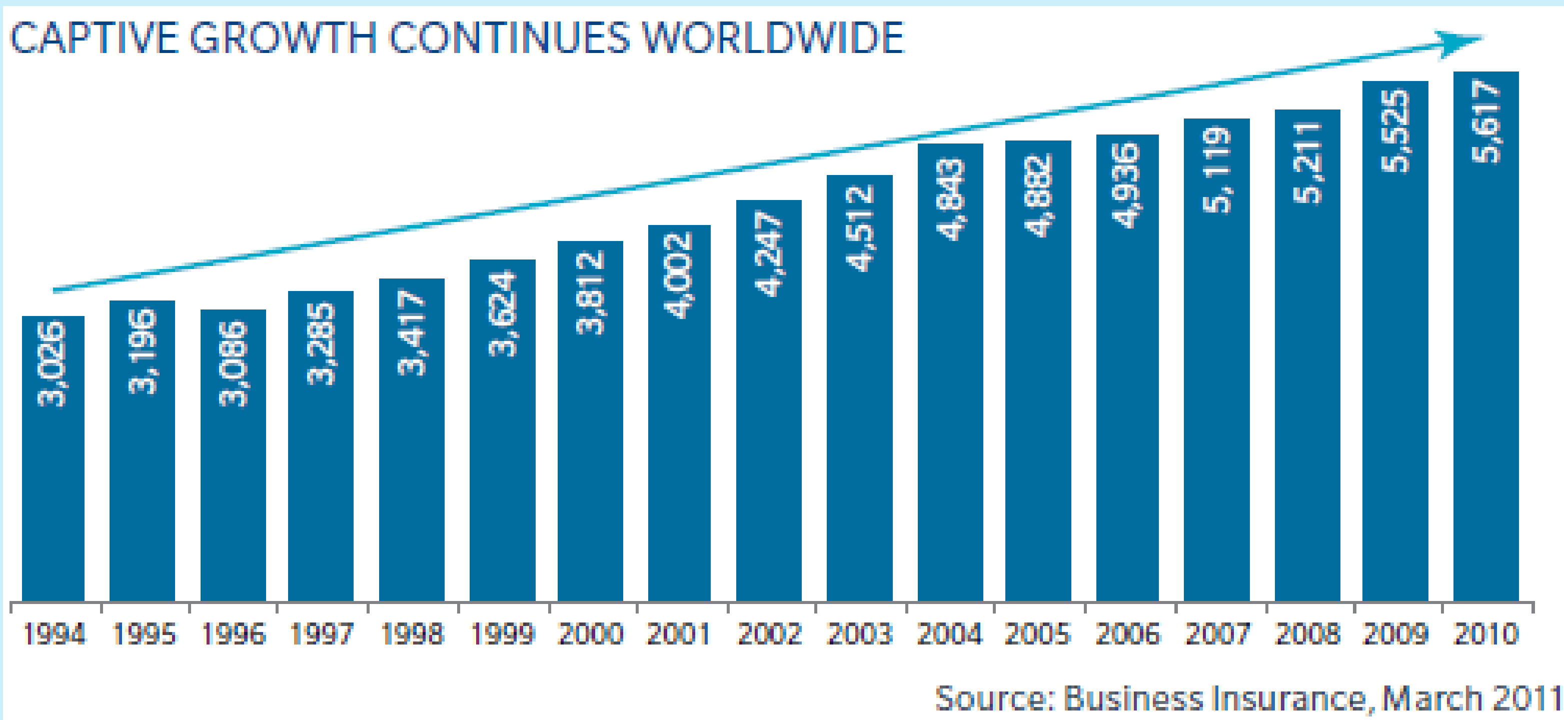
- Worker's compensation
- General liability
- Product
- Auto
- Medical malpractice
- Environmental
- Professional
- Health

Domiciles Summary*

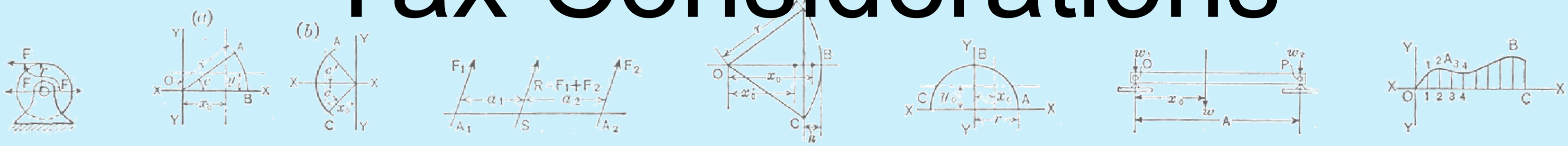


* Business Insurance 2012 *Market Insights*

Captive Growth Continues



Tax Considerations



Federal tax acceleration

- Current tax benefit of deduction for *captive reserves* vs. NPV of future tax deductions on paid claims

State

- Premium tax vs. income tax

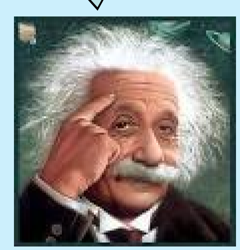
International

- Cross border tax arbitrage

Other taxing issues

- PFIC, 953D, Nexus, risk shifting/distribution, CFC,
- Dividending, subpart F income, PLR, FET, UGH!

2% to 3%[1] tax savings on self insured losses - , so this is what all the fuss was about?



(1) http://www.captive.com/service/milliman/article4_tax.shtml

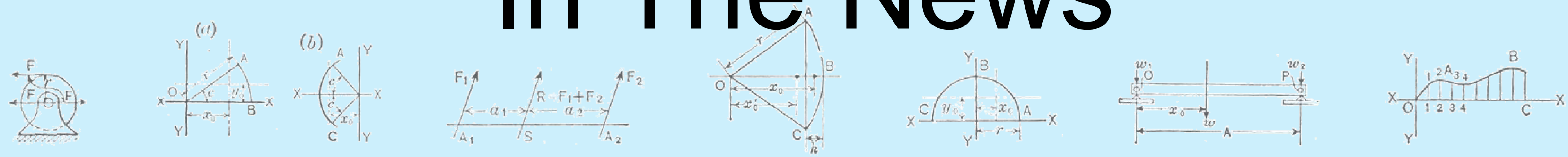
Capital Considerations

- Capital required to support underwritings
- Determined by premium written, reserve analysis, and domicile regulations

Rules of thumb

- Premium to surplus — no higher than 1.50
- Reserves to surplus — no higher than 3.50
- Surplus to liability retention — no less than 10 Probability of ruin analysis

"In The News"



Federal Issues

•Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 - applicable to captives?

State issues

•State self procurement tax changes

International Issues

•The European Union Solvency II Directive, (January 1, 2014), - may increased capital requirements 300%

Looking Ahead

•Legislation introduced in Congress to amend the Liability Risk Retention Act of 1986 proposes to permit risk retention groups to cover property insurance.

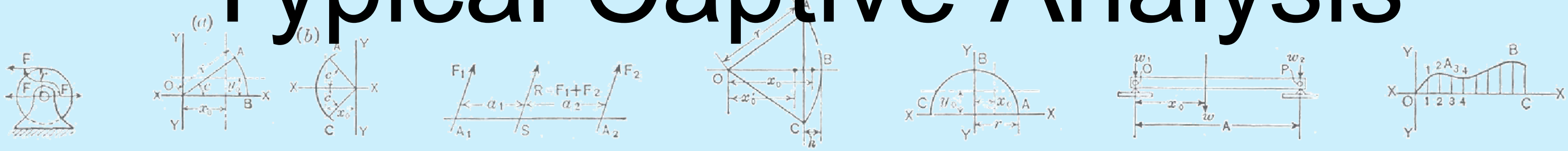
Reserve Analysis

Einstein discovers that the speed of light is 186,000 miles per second, but the speed of Lite beer is only 65 MPH.

Typical Actuarial Report

1. Loss Development
2. BF
3. Frequency/Severity
4. Anything else that seems appropriate

Typical Captive Analysis



1. Loss Development
2. BF
3. Frequency/Severity
4. Anything else that seems appropriate

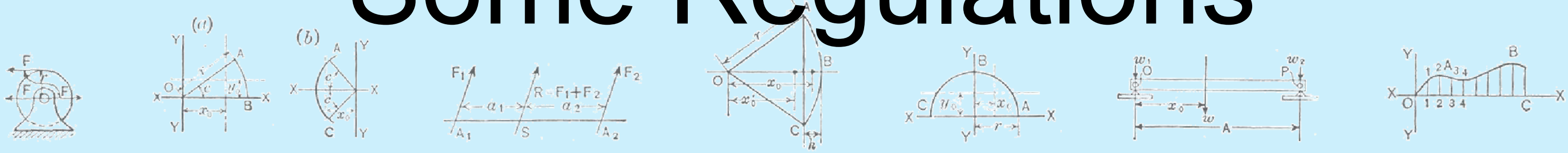
Typical versus Typical

- Look at regulations / talk to regulators
- Talk to other actuaries
- Talk to clients
- Talk to auditors

Some Regulations

1. The annual audit shall include an opinion as to the adequacy of the company's loss reserves and loss expense reserves
2. Certification shall be in such form as the commissioner deems appropriate

Some Regulations

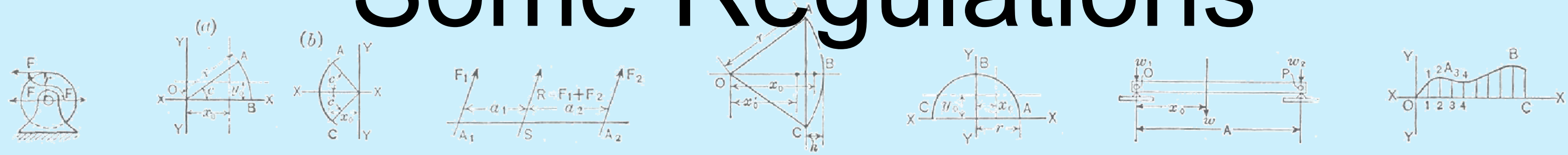


The statutory financial return … shall include the opinion of a loss reserve specialist in respect of the insurer's loss and loss expense provisions

Some Regulations

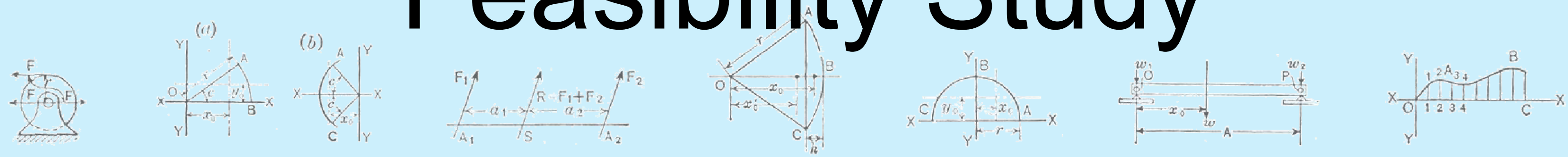
… prepare annually an actuarial evaluation of its assets and liabilities, certified by an actuary approved by the Authority, so as to enable the Authority to be satisfied as to its solvency.

Some Regulations



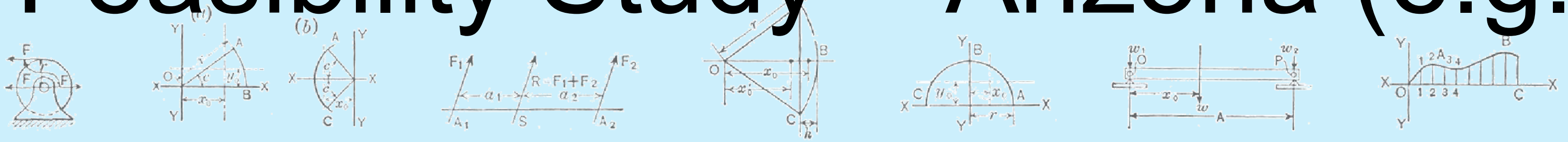
- A feasibility study certified by an actuary
- A Schedule P like amount of data

Feasibility Study



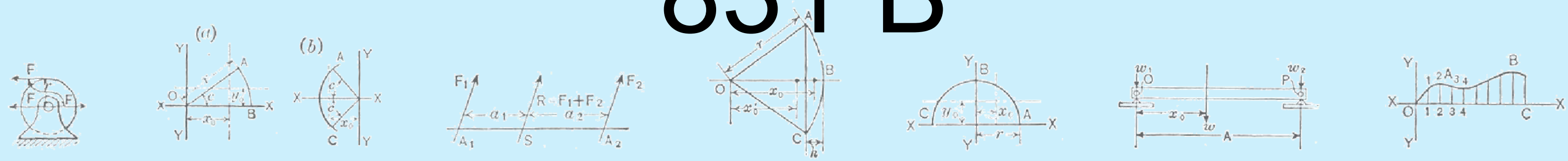
- Soup-to-Nuts?
- Probably not
- Usually the captive manager would put most of info together and present to the domicile

Feasibility Study – Arizona (e.g.)



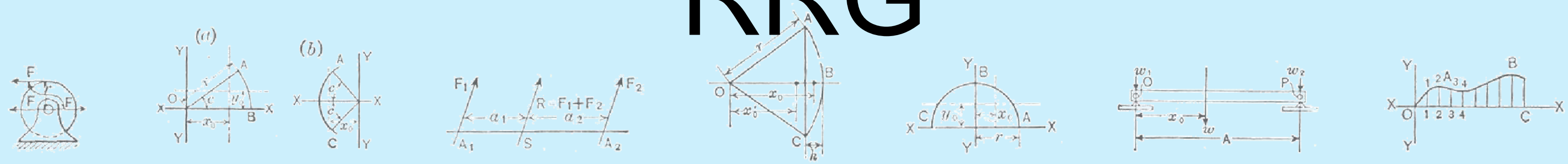
- Be prepared on the actuary’s letterhead;
- Include a description of all documents and materials the actuary reviewed and an explanation of how the feasibility study comports with the business plan (e.g. risks, coverages, retentions, and whether the proposed non-RRG captive will write business directly, cede, or assume business);
- Review of 3-5 years of loss history specific to the proposed insured population and the business plan;
- Identify the methodology used in preparing the feasibility study including confidence levels, credibility, expected results, worst and best case scenarios with premium and loss components; and
- Include conclusions on proper capitalization and pricing.

831 B



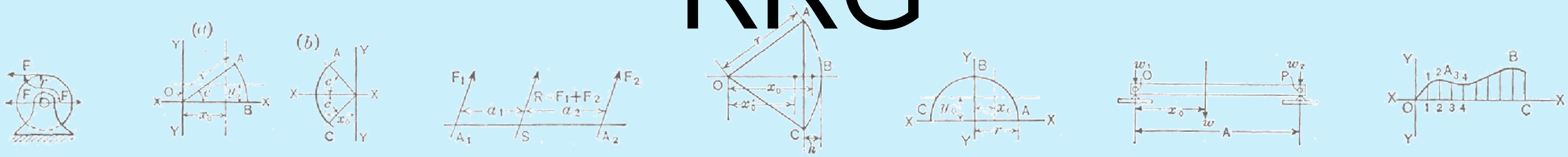
- An actuary may do more with an 831 B
- Justify premium on front end
- Never see premium again?
- Only review reserves?

RRG



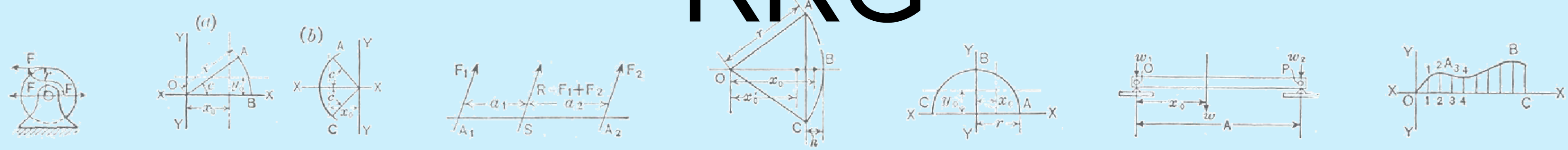
- More Schedule P like
- Reconciliation of data
- Actuarial opinion summary

RRG



- Pro-forma projections
- 3-5 years
- Adverse scenario

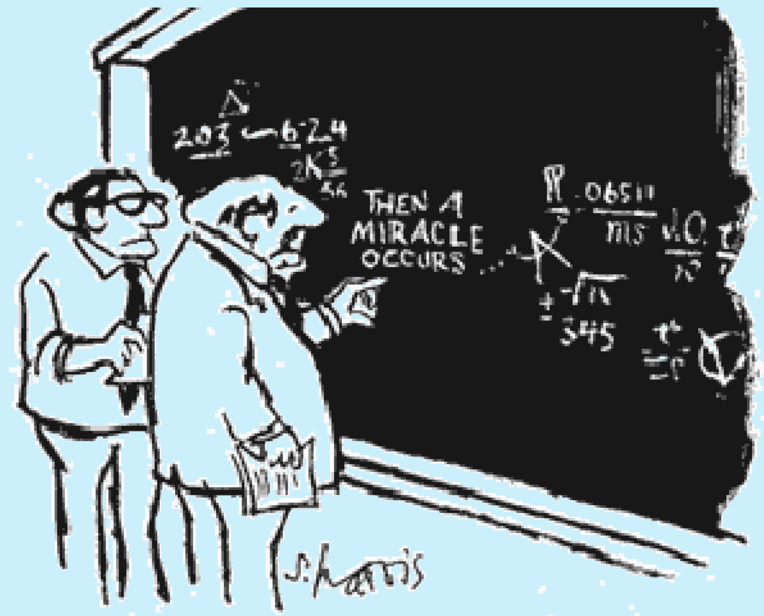
RRG



- What would happen to capital?
- Loss projection at higher confidence levels?
- Captive manager probably runs through the pro-forma

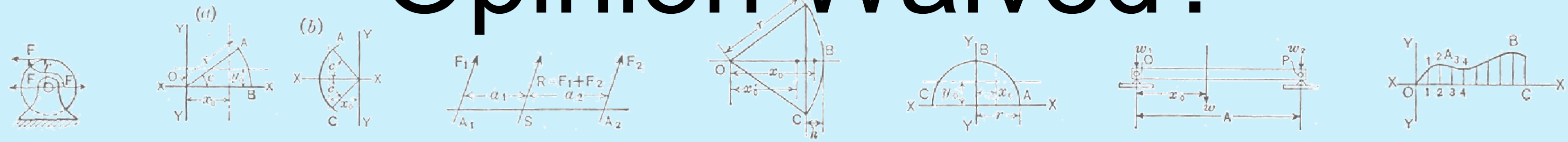
What Gets Waived?

- Schedule P
- Opinion letter



"I THINK YOU SHOULD BE MORE EXPLICIT HERE IN STEP TWO."

Opinion Waived?

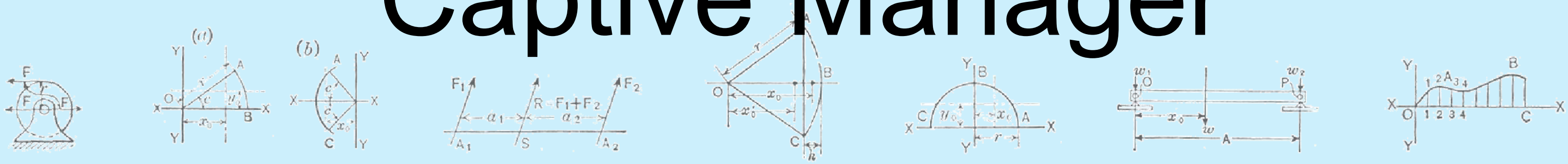


- Small company exemption – premium or loss driven
- Undue hardship – case by case basis
- Nature of business written

Collaborative

- Captive departments seem more collaborative than traditional insurance departments
- If results deteriorating, a domicile is more likely to work with captive and actuary for reasonable solutions
- Not looking for specific ways of doing something and checking a box

Captive Manager



- In the feasibility stage, wants to talk with an actuary to get things started
- Actuary is the key link for economic and financial analysis
- Wants actuary involved with risk manager and CFO or Treasury

Captive Manager

Board Reporting, Planning & Governance

- Needs projected losses
- Needs payout patterns
- Needs to understand and explain results

Captive Manager

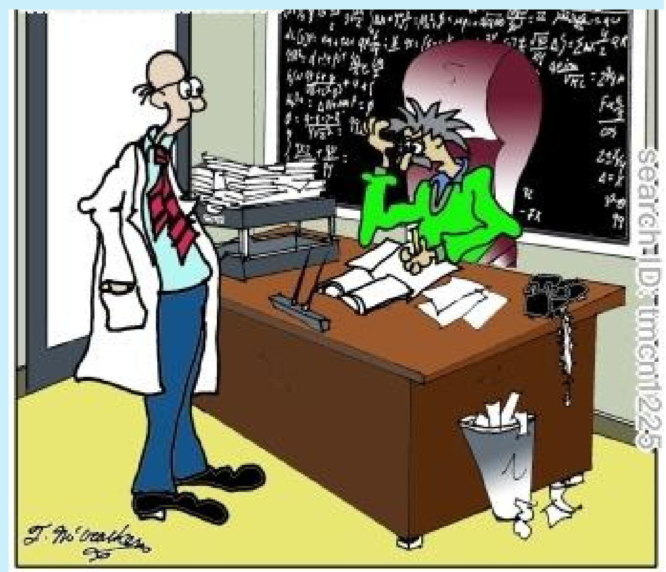
- High degree of scrutiny of audits, depending on materiality of risk
- Typically, two actuaries review annual results (consulting and audit firm)
- Risk managers are more sensitive to earnings environment
- Mid-market risk managers are often the CFO

Captive Manager

- An increasing amount of interim work for public companies – NO surprises
- Common to do an analysis in Sept/Oct to get ready for year end

IRS Perspective

- Is the captive an insurance company?
- Reserves determine tax deductibility
- Reserves meet certain minimum reasonableness tests
  - Set within 5%-10% of actuary estimation
  - 75% percentile



“Just because I can explain the theory of relativity doesn't mean I understand the tax code.”

In Summary