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Actuarial Considerations in the Preparation and Review of Nevada Captive Insurance Applications

Gennady Stolyarov II*, FSA, ACAS, MAAA, CPCU, ARe, ARC, API, AIS, AIE, AIAF*
Lead Actuary*, Property and Casualty Insurance*
Nevada Division of Insurance
Contact: *gstolyarov@doi.nv.gov*

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Admissions: Actuarial Analysis

- A new captive insurer does not yet have historical experience which can be analyzed.
- **NRS 694C.210(2)** requires a captive insurer applying for a license to submit a *pro forma* financial statement that has been prepared by a certified public accountant (CPA) or actuary authorized by the NVDOI to conduct business in Nevada. (Section 4 of Captive Application)
- *Pro forma* financial statement is forward-looking, attempts to anticipate the future.
- **For risk-retention groups:** RBC projections required for all new applications since 2014.
- **Key questions:** Are the projections reasonable? What are the crucial assumptions? What happens in an adverse scenario?
- **Examples of causes for adverse scenarios: (i)** Less premium written than anticipated; **(ii)** Many more losses than anticipated – possibly including one or more large, catastrophic losses; **(iii)** Extremely high operating expenses; **(iv)** Reinsurance that is disadvantageous to the captive.

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Admissions: Actuarial Analysis

(Continued)

- NRS 694C.210(4)(a) requires the captive applicant to provide evidence of the **amount** and **liquidity** of its **assets** *relative to the risks* to be assumed.
- ★ Ultimately, liquid assets in excess of liabilities are the captive's best protection against adverse deviation.
- **Actuarial feasibility study** is included as part of Section 3 of the captive application. Feasibility study includes:
  - Estimated premiums to be collected
  - Estimated loss costs
  - Impact of any reinsurance / pooling arrangements
  - Estimated expenses
  - Estimated investment income
  - Expected profit and capital/surplus growth
  - Confidence levels for estimates
  - ★ **Documentation of methods, assumptions, and calculations.**

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Key Questions to Consider

- **Whom** does the captive insurer impact? Just the parent entity, or third parties as well? Are the third parties natural persons or "sophisticated" consumers?
- What **lines of business** does the captive insurer plan to write or reinsure? Medical malpractice and workers' compensation (may not be written directly) insurance receive particular attention.
- Are the assumptions regarding expected premiums and losses reasonable?

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Reinsurance

- Reinsurance can fundamentally transform the nature of a captive insurer's operators and affect exposure to the general public. Many captive insurers, especially risk-retention groups, have failed because of unfavorable reinsurance terms. **Reinsurance is not required in Nevada!**
- Pursuant to NAC 694C.250 and NAC 694C.270, entry into *any* reinsurance agreement, or the termination or modification of *any* reinsurance agreement, apart from its natural expiration, requires the NVDOI's prior approval.
- **Considerations**
  - Is the reinsurance reasonably priced?
  - Are there are aspects of the reinsurance agreement – such as large minimum premiums, "corridor deductibles", or swing-rating – that render the reinsurance onerous to a small company?
  - Could commutation and/or surplus accumulation be superior options for protection against large adverse deviations in losses?

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Common Pitfalls – Technical

- Calculations and formulas not clearly presented or erroneous.
- Erroneous statements that ALAE = DCCE and/or ULAE = AOE. Nevada is indifferent as to whether the ALAE/ULAE or the DCCE/AOE classifications of loss-adjustment expenses are used – *but they are not equivalent.*
- Assumptions for adverse scenarios are not explained.
- Adverse scenarios are insufficiently adverse. One additional $100,000 loss or a 5% increase in the loss ratio does not qualify as a reasonable adverse scenario! (The intent is to see how the captive would perform in a truly stressed outcome that is within the realm of possibility.)

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Common Pitfalls – Procedural Hypercaution

- **"Draft" or "Not to Be Relied Upon" wording:** If you say we cannot rely on it, we will not rely on it – *but the application will not be approved until we can.*
- **Refusal to express an opinion:** Pursuant to the U.S. Qualification Standards, any Actuarial Feasibility Study by a credentialed actuary is considered a Statement of Actuarial Opinion (in the general, not necessarily statutory, sense). If you cannot opine as to the reasonableness of your work, neither can we.
- **Confidentiality:** May apply vis-à-vis the general public, but nothing is confidential from regulators.
- **Remember:** Sometimes real and 100%-certain delays can occur due to efforts to protect yourself from remote, purely hypothetical contingencies. If you have concerns, discussion is preferable to "boilerplate" wording that defeats the purpose of your engagement.

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Uncommon Pitfalls

- **Pseudo-Insurance:**
  - **Example:** "Tax Indemnity" Coverages for 831(b) Captives: Self-Referential Premium Spiral – Possibility of infinite "premium" due to divergent arithmetic series – Encourages taking risky tax positions
- Expected scenarios more adverse than the "adverse scenarios"! **Check your entries and calculations!**
- Projecting more favorable tax treatment or offsetting adjustments for an adverse scenario, *before* the adverse losses occur. (E.g., the company management somehow anticipates that it needs to increase premium in Year 2, even though the adverse loss is projected to occur in Year 3.)

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Questions?