Captive Basics and Trends for the Casualty Actuaries : Economic Benefits

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Maila Aganon, ARM, ACI
Captive and Insurance, Manager – Caesars Entertainment Corp.

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Objectives

- Provide a practical overview of how captives are utilized
- Illustrate the economic and risk management benefits of the captives
- Explain how the actuarial role contribute to the success of the captives

Brief overview of captive utilization

- Bermuda captive founded in 1990 which primarily covers general liability, workers compensation, marine coverage and property insurance
  - ✓ $275 million in assets; ~$70 million in annual premium
- Nevada captive founded in 2006 which primarily writes terrorism coverage, property insurance and surety bonds
  - ✓ $16 million in assets; ~$6.5 million in annual premium

Benefits – Reduction of Total Cost of Risk

- Improved control of risk management program
- Improved cash flow and lower cost of capital
- Cost efficiencies including access to reinsurance
- Profit opportunities
- Tax considerations

Improved Control of Risk Mgt. Program

- Increased control of claims management
  - ✓ Loss prevention – by taking some element of risk, the program's focus shifts to prevention and safety programs
  - ✓ Claims administration – allows owner to choose specific partners and to select appropriate methods of claims adjudication
- Provides for the ability to pool risks
  - ✓ Allows for single deductible to properties
  - ✓ Provides a guaranteed cost insurance for properties that "can't afford" fluctuation or adverse results
- Improved cost allocation and tracking
  - ✓ Allows owners to allocate equitably among properties
  - ✓ Cost transparency – higher utilization equals higher cost

Improved Cash Flow and Lower Cost of Capital

- Much of the insurance company's profit loading is removed from the premium calculation
  - ✓ Lower overhead cost and profit margin
  - ✓ Retention of underwriting profit
- Earn investment income on assets
- Ability to repatriate money back to the owner via dividends
- Capital remains within the fiscal group
- Utilization of captive assets as collateral (i.e. Reg. 114 trust)

Increased Cost Efficiencies

- US based captive can access the Treasury's Terrorism Risk Insurance Program Reauthorization Act (TRIPRA)
- Nevada based captive can write surety bonds to Nevada governmental agencies without collateral requirements
- Direct access to reinsurance markets. The captives access reinsurance companies for the property program and terrorism insurance

Profit Opportunities

- The calculation of premium charged by the captives is as follows:
  - ✓ Premium = expected losses + operating expenses
- Expected losses are based on actuarial estimates and such estimates may change during a given period. Reasons for a change may include:
  - ✓ Actual loss experience differs from initial estimates
  - ✓ Changes in exposures to risk
- Since actual losses at the end of a given period may differ from initially estimated losses at the time premium is underwritten, the captive may produce net income or loss.

Tax Considerations

- The captive must qualify as an insurance company in order to derive the tax benefits
  - ✓ Premiums paid to captives by subsidiaries are tax deductible.
  - ✓ A captive allows for the deduction of unpaid losses
    - ➢ Insurance companies can deduct loss expenses when they are reserved for as opposed to when they are paid. This can result in positive tax cash flows for tax purposes
    - ➢ Long tail business such as workers comp, general liability and auto liability provides for this tax advantage.

Captive Operations Key Players

- Captive manager as the “right hand” of the operations
- Third Party Administrator as the “biggest spender”
- Investment Managers “monopoly players”
- External Auditor keeps the company “straight”
- Legal Counsel “spells out the law”
- Internal Business Partners “ information provider”
- Actuary as “owner’s best friend”
  - ✓ Plays part in all of the captive operations and life’s cycle

The Role of the Actuary

- Predict loss costs
- Develop premium rates
- Provide additional modeling services
- Assist with product line reviews
- Assist with regulatory examinations
- Assist in captive buy and sell decisions

Other Valuable Actuarial Services

- Provide expanded loss reporting and other special analysis
- Assist with insurance cost allocations
- Participate in dynamic financial analysis
- Assist management in determining appropriate mix of investments given estimated future payout patterns

Keys to Success with a Captive Owner

- Get to know the captive owner
  - ✓ Understand the business model, core values, motivations and expectations
- Be proactive and innovative
  - ✓ Provide solutions even if it has not been tried before
- Speak the owner’s language
  - ✓ Provide executive summary with your analysis’