Captivated by Captives

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Agenda

- Captive background
- Myths and legends
- Actuarial concerns
- What's new
- Questions

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.

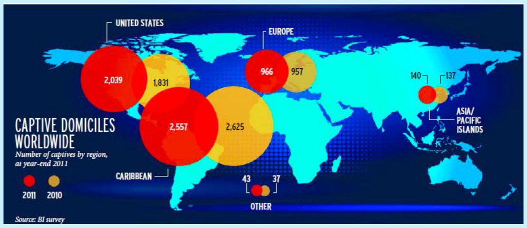
Types of Captives

- 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)

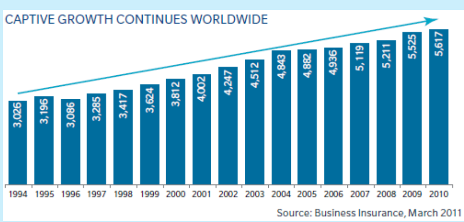
- Property
- General liability
- Worker’s compensation
- Product liability
- Auto
- Medical malpractice
- Environmental
- Professional
- Health

*Domiciles Summary**



* Business Insurance 2012 *Market Insights*

Captive Growth Continues



Myths and Legends

QUIZ![1]

(1) The correct answers to this quiz are often subjective and arguable. The opinions expressed herein are solely the opinions of the author. Some answer may be better than others and some may be downright silly. If there is any disagreement with an answer, please feel free to express your viewpoint and they will be promptly ignored by the moderator.

Practice

- Question: E = MC ?
- A. Hammer
- B. Squared
- C. Y (MC) A
- D. Some will pick this answer just because it has the most words.

There are about how many US captive domiciles

- A. 17
- B. 38
- C. 51 (includes D.C.)
- 3.1415926

A wholly owned captive can write any type of insurance

A. Myth
B. Reality

"Thank you for gently guiding me toward insight."

Self insuring in a captive will allow greater control over claims and loss control

A. Myth
B. Reality

In a US domicile, actuaries are needed for only captives that have over $1,200,000+ in liability reserves

A. Myth
B. Reality

Anyone can set the reserves in a captive if the captive writes only the risk of the parent

A. Myth
B. Reality

After a feasibility study is complete, the incorporation process takes about two to three weeks

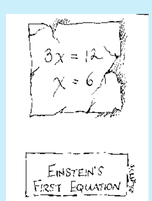
A. Myth
B. Reality

The main difference between domiciles is geography

A. Myth
B. Reality

Accessing the reinsurance market directly through a captive will save about 30% on premium spend

A. Myth
B. Reality



Given new IRS revenue rulings , (stating the IRS will no longer contest the brother sister argument) corporations can deduct all reserves in a captive?

A. Myth
B. Reality

The federal deduction of premium as an expense is the greatest tax benefit of a tax qualified captive

A. Myth
B. Reality

The CFO is often most concerned with the cost of capital in a captive

A. Myth
B. Reality

Given the A fund, B fund mix in a rent-a-captive, there is no risk of loss to the participant

A. Myth
B. Reality

I can manage all the affairs of my captive from my corporate office limiting travel expense

A. Myth
B. Reality

As it's your captive, you can set whatever premiums you want for your insurance

A. Myth
B. Reality

If no insurance company for federal tax, there are no tax issues

A. Myth
B. Reality

Corporate tax rate 30%, federal captive for tax, WC premium = $1,000,000, tax deduction at captive is $300,000

A. Myth
B. Reality

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

You do not need to pay self procurement tax as the regulations are vague and nexus can be shown with other states

A. Myth
B. Reality

831b companies are available as tax shelters for any company and risk as it's IRS code

A. Myth
B. Reality

Medusa, first thing in the morning.

12 subsidiaries will pass IRS muster for a brother-sister argument

A. Myth
B. Reality

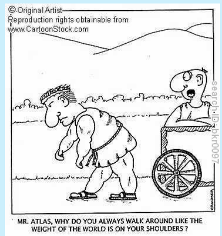
Achilles often feared that his weakness would be discovered.

An in depth feasibility study must be done before forming a captive

A. Myth
B. Reality

Building up retained earnings over time in a captive is a good idea as it smoothes the corporate budget in case of a large loss

A. Myth
B. Reality

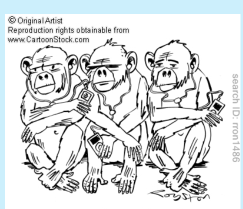


Captives can invest reserves in any type of financial instrument

A. Myth
B. Reality

Loan back of captive funds to the parent are ok

A. Myth
B. Reality



Actual Support

- Feasibility study
- Ratemaking
- Reinsurance / retention analysis
- Reserving/actuarial opinion
- Other actuarial support

Feasibility Study

- Five-year Pro forma Projections
  - Balance sheet, Income statement, Cash flow statement
  - SAP or GAAP
  - Input from owners/management – capital contribution, expenses, etc.
  - Projected loss ratio, funding
  - Reinsurance
  - Scenario testing
  - Evaluation of key statistics – leverage ratios
  - Refine operating plan
  - Does coverage meet requirements of insurance for premium deduction?

Ratemaking

- Historical exposure and claims
  - Ideal data probably not available
  - Lack of volume/credibility
  - Prior insurers may not provide case reserves/open claim info
  - Changing exposures or coverage
- Industry benchmarks
  - Market rates and loss ratios
  - Loss costs
  - Claim frequency/severity
  - Inflationary trends
  - Increased limits factors
- Industry sources
  - Rate filings
  - ISO
  - NCCI
  - Annual Statements / Schedule P
- Actuarial Judgment

Ratemaking

- Expenses
  - Management fees
  - ULAE costs
  - Accounting/audit costs
  - Consulting fees (actuarial, regulatory, etc.)
  - Risk management program costs
  - Investment expense
  - Taxes
  - Board or committee meetings
- Other considerations
  - Consideration of investment income on reserves and surplus
  - Risk margin
  - Surplus contribution

Reinsurance/Retention Analysis

- How much exposure can the captive keep
  - Analysis may be part of feasibility study
  - Capitalization relative to claim cost volatility
  - Leverage
  - 10% rule (A single net loss should not be more than 10% of surplus)

Reserve Analysis/Actuarial Opinion

- Reserve Analysis
  - Apriori from feasibility or ratemaking studies
  - May need to rely on industry development patterns
- Reserves estimate/opinion may differ by domicile
  - Reasonable or adequate standard
  - Expected value or w/risk margin
  - Discounting
  - March 1st or June 1st opinion

Other Actuarial Support

- Provide performance benchmarks
  - Loss Costs, expected claim development, frequency severity
  - Industry loss and expense ratios
- Board presentations
  - Help educate Board on basic actuarial concepts
  - Basic reserving, loss development
  - Basic pricing = sum of claim costs + expenses
  - Reserve development
  - Calendar year versus coverage year results
  - Allocation methodology, credibility of experience

"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.

In Summary