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Structuring Captive Insurance Programs: Key Provisions, Regulatory Requirements, Risk-Pooling Arrangements

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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What is a Captive?

- An Insurance or Reinsurance company owned by the Insured

Types of Captives

	Single Parent	Sponsored Cell Captive	Association / Group Captive	Risk Retention Group
Scale	>$1M in premium	Any minimum premium level	Typically a min. of $250k in premium, no maximum	Any premium volume
Features	• Medium to Larger account solutions • Unilateral control of captive (subject to regulator) • No risk sharing, unless pooling arrangement is deployed	• Typically established by a 3rd party sponsor • Insured can “rent” the captive space • Typically lower operating costs • Could be a protected cell or incorporated cell structure • No risk sharing	• Sharing risk is required • Access to profitability of insurance program • Considerably greater control as compared to guaranteed cost insurance • Lack of unilateral control of services and risk • Communal risk management	• Sharing risk is required • Policy holders are share holders • Formed in a state/domicile and ability to write in all 50 states • Liability insurance only • Typical Industries: Healthcare, transportation, governments and professional services

Why Are Captive Formed?

- Control
- Control
- Control

Why are Captives Formed?

Control
Management of claim
Program design

Coverage
Fill coverage gaps
Exclusions for difficult risks

Capacity
Access to reinsurance

Captive
Strategic enabler

Compliance
Potential tax benefits
Premium allocation

Cost
Leverage the market

Commercial
Affinity programs
Extended warranties

Benefits

- Opportunity for favorable risk management business outcomes
- Recapture gaps in traditional risk transfer solutions
- Opportunity to take risk and profit positions in affiliate business
- Control frictional and non-loss costs
- Global consistency of coverage
- New capacity for certain risks
- Ability to provide stable insurance protection year-to-year
- Enhanced claims service with focus on loss prevention and reasonable claim resolution

Types of Risk

Auto (Deductible Reimbursement)

Property (Deductible Reimbursement)

Exclusions on Traditional

D&O Professional Liability

EPLI

Warranty Risk

Environmental Liability

Regulatory Liability

Traditional Lines

Emerging Lines

CAPTIVE

Insurer / Reinsurer

Investigations / Audit Risk

Cyber Security

Key Accounts

Workers Comp.

Supply Chain Disruption

Reputational Risk

Quake, Flood or Rain

Insurable Risk

Yes	No
Hazard Risks	Financial Risks
Operational Risks	Strategic Risks
Pure Risks *(Loss)*	Speculative Risks *(Gain or Loss)*

Considerations

- Incurring unexpectedly large losses
- Compliance issues
- Meeting and maintaining capital requirements
- Competing uses for available capital
- Accessing capital for competing needs
- Distributing profits
- Winding down program
- Restrictions on selling or transferring ownership
- Focus and commitment must be long term
- Overcoming the learning curve

Chief Consideration

- Who Owns the Captive
  - Why?
  - How?

What is a Captive for?

- A captive is a vehicle for financing risk that is retained by the insured(s).
- Business owners and managers should ask themselves, “What risk do I want to retain?” and “What risk do I want to transfer?”
- The answer will depend on various factors, particularly on the availability and cost of insurance in the commercial market.
- The questions cannot properly be answered without first identifying risks within the business.

Other Reasons for a captive

- How do I want to spend my risk dollars?
- Where do the profits go?
- Who gets the benefit?
  - You
  - Your heirs
  - A charity
  - A company
  - Talk to an expert as many things are in play

Captive Formation Process

1. Review Current Insurance Program and Risk Appetite What do I want to Insure?
2. Who will own it, and how?
3. Select Captive Team (Consultant and Captive Manager)
4. Risk Assessment & Feasibility
5. Decision to Proceed
6. Business Plan and Insurance Program Development
7. Captive Application, License, Incorporation & Capitalization
8. Commence Operations Including Premium Funding and Policy Issuance

Domicile Selection

- Domicile
  - Laws and regulations separate and independent of other insurance laws
  - Regulators are different and, theoretically, more disposed to captives
  - On shore, in the US, versus Offshore
    - Offshore usually Bermuda, the largest domicile, or Cayman
    - Onshore includes 30+ states and territories

No matter where it is located, KNOW YOUR REGULATOR

Domicile Selection

Criteria	Criteria
• Statutory Capitalization and surplus requirements and solvency ratios • Receptiveness of regulatory environment • Quality of local infrastructure • Availability of expertise • Stability of regulatory environment	• Flexibility as respects investment portfolio • Ease of doing business – in a suitably regulated environment • Expertise in business under consideration • Efficient financial outcomes: tax, wealth, investment, etc.

Actuarial Risk Pricing

Third party actuaries should NOT price loss exposures that do NOT represent real insurance risk. Rigorous methods and assumptions develop expected loss estimates for each coverage.

Insurance Must…

- Reflect a shift of both economic loss and timing of payments
- Represent a material risk (probability) of a material loss

Actuarial Methods Utilize…

- Pricing from public information
- Rate filings for similar coverage
- Past claims history
- Reinsurance techniques when little public data exists

Actuarial Reports Must…

- Comply with the highest actuarial standards and be easily reviewable by other actuaries and regulators
- Understand captives

Taxation of Captives

- **DO NOT FORM A CAPTIVE FOR TAX REASONS**
- **Talk to a real captive tax expert**
- **Tax requirements for true insurance**
  - Risk shifting: risk of loss is shifted from the insured to a financially viable and bona fide insurer for an arm's length premium
  - Risk distribution: numerous, independent risks, and the associated premiums, are "pooled"
  - Insurance risk: risk of a "fortuitous event"; not business or investment risk
  - Insurance in the commonly accepted sense: customary insurance formalities observed

Taxation of Captives

- **Congress takes action**
  - Micro-captive diversification requirements:
    - Shareholder diversification: descendants of insured's owners can't have more than a 2% greater ownership interest in the captive than in the insured; or
    - Policyholder diversification: no more than 20% of premiums attributable to any one policyholder
  - Micro-captive can receive up to $2.2MM in annual new written premiums (up from $1.2MM)
    - Limit is also indexed for inflation ($2.3MM in 2018)
  - Passed 2015, effective 2017

Taxation of Captives

- **IRS takes action**
  - Notice 2016-66 (Nov. 1, 2016): specified micro-captive transactions designated a “transaction of interest,” triggering extensive reporting to IRS by captive and its material advisors
    - Reporting required if 20% ownership overlap and either (a) less than 70% loss ratio or (b) “producer” loans, etc.
  - Litigation:
    - *Avrahami* (2017)
    - *Reserve Mechanical* (2018)

Taxation of Captives

- **Where are we now?**
  - Prudently structured and maintained captives are as viable as ever, but more IRS scrutiny
  - Many micro-captives are using 80% risk pools after 2016 to permit captive ownership diversification
  - Other tax advantaged captive structures may be available
  - ***Manager and advisor selection is critical!***
  - Remember that taxes are only one potential benefit of a captive insurance program

Thank You

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