Captives 101 - Understanding Captive Basics

Michael Zuckerman, Associate Professor Instruction, Temple University Fox School of Business
Heather McClure, Chief Risk Officer, OU Health
Theresa Carpenter, Senior Consultant, Hylant Global Captive Solutions

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Risk Appetite and Tolerance
Risk Appetite AND TOLERANCE Spectrum

- **Guaranteed Cost**
  - Complete transfer of risk
  - Commercial insurance with no deductible

- **Retro Policy**
  - Assumption of limited risk in exchange for potential return premium
  - Deferred “pay-in” premium

- **Deductible Policy**
  - Significant/complete risk assumption in exchange for deductible credit

- **Group Captive**
  - Pooling of Risk with Participants subject to Corporate Governance
  - Complete assumption of risk
  - Subject to Regulatory Oversight

- **Single Parent Captive**
  - Complete assumption of risk

- **Self-Insured Trust**
  - Complete assumption of risk with limited regulation
Risk Transfer v. Risk Retention

EXPOSURES
- People
- Assets
- Customers

RISKS
- Product
- Auto/Trucking
- EPL
- Cyber
- WC
- CAT Risk
- Professional/E&O
- Environmental
- Benefits

TRANSFER RISK

RETAIN RISK
Determining your Risk Tolerance

Measured as a % of:

- √ Retained Earnings
- √ EBITDA
- √ Net Cash Flow
- √ Unique Industry/Organization KPIs

The ultimate decision is tempered by individual company philosophy, risk tolerance, business development goals, shareholder expectations, etc.
Who Should Consider a Captive?

- Financially stable
- Good claims history
- Good risk management practices
- Willing to work with other companies (potentially competitors)
- Willing to make a long-term commitment
- Willing to be proactive
- Low loss ratio
- Willing to invest in themselves

Company or Group of Companies
Current Trends

- Trade Credit
- Workers Comp
- Medical Stop Loss
- DIC/DIL
- Active Shooter
- Defense Costs
- General Liability
- Key Client
- D & O
- E & O
- Pollution Liability
- Supply Chain
- Business Interruption
- Anti-Trust
- Aviation
- Medical Stop Loss
- Auto Liability & PD
- Property
- Executive Risk
- G/L and Products
- Trade Credit
- DIC/DIL Policies
Captive Industry Growth

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Source: Business Insurance, 2020 Captive Managers & Domiciles, Rankings + Directory: 8
What is a Captive?

A *licensed insurance company* owned and controlled by those it insures

- Insures or reinsures the risk of its parent(s) or affiliated companies
- Formalized mechanism to finance *self-insured risk*
- Requires capital
- Operates outside of the commercial insurance market
- Used to accomplish risk financing goals
Types of Captives

**CELL CAPTIVE**
- Segregated/protected or incorporated cell
- Formed by a third party sponsor who “rents” cells to unrelated companies
- Assets and liabilities of each cell are segregated from other cells
- Typically lower start-up and frictional costs than SPCs
- Each cell owner is typically required to capitalize that particular cell

**GROUP/ASSOCIATION**
- Owned by multiple companies who are also shareholders
- Sharing of un-controlled risk, liabilities, and profits
- Insures or re-insures the risk of the entire group

**RISK RETENTION GROUP**
- Specific type of group captive
- Regulated under U.S. federal legislation
- Licensed in one state and able to operate in all 50 states on a registered basis
- Can only write liability lines of risk – no workers compensation or property

**SINGLE PARENT**
- Owned by one company
- Insures or re-insures the risk of its parent, subsidiaries, or chosen unaffiliated parties
Single Parent vs. Group Captive

Single Parent Captive
- Typically owned by and insuring one entity/individual and affiliates.
- No sharing of risk with unrelated third-parties.
- Can issue direct and reinsurance policies.
- Broad application across various risks/exposures.

Group Captive
- Risk sharing is crucial to the function of the captive.
- Typically limited to traditional P&C risks/exposures.
- Must engage with fronting carrier to issue policies.
- All insureds are owners/shareholders.

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BUILDING ON THE BEST
Captive – Strategic Value
Why are Captives Formed?

Control
Management of claims
Program design

Capacity
Access to reinsurance

Cost
Leverage the market

Coverage
Fill coverage gaps
Exclusions for difficult risks

Compliance
Legal and tax certainty
Premium allocation

Commercial
Affinity programs
Extended warranties

Captive
Strategic enabler
Sample Types of Risks

**Traditional Lines**
- Workers Comp.
- Auto (Liab & PD)
- General Liability
- Professional Liability
  - Property
- CAT Risks (Quake, Flood, Wind)
  - Environmental
  - Directors & Officers
  - Employment Practices

**Emerging Lines**
- Warranty Risk
- Construction Risks
- Regulatory Liability
- Network/Cyber Security
  - Wage & Hour
  - Reputational Risk
  - Executive Risk
  - Benefits

**Third-Party Risk**
- Voluntary Benefits
- Extended Warranty
  - Supply Chain
    - Suppliers
    - Vendors
    - Customers
      - franchisees

Hylant Global Captive Solutions
Why Consider a Captive?

**Financial**
- Reduce total cost of Risk
- Potential short- and long-term savings
- Financial reward for being better-than-average
- Cashflow - Capture investment returns
- Reduce frictional costs
- Remove traditional insurer’s profit loading
- Potential profit center

**Control**
- Access to capacity
- Claims manage me
- Ability to better manage premium volatility from year-to-year
- Power to reduce costs over time by controlling losses
- Be rewarded for good loss prevention and claims management

**Flexibility**
- Ability to craft coverages to meet specific insured’s needs and enable organizational strategy
- Options for customized value-added services
- Insulated from market conditions; address insured needs, not the insurance market
## Considerations

<table>
<thead>
<tr>
<th>Distributing profits</th>
<th>VARIATION = Incurring unexpectedly large losses</th>
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</thead>
<tbody>
<tr>
<td>Winding down program</td>
<td>Compliance issues</td>
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<tr>
<td>Restrictions on selling or transferring ownership</td>
<td>Meeting and maintaining capital requirements</td>
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<tr>
<td>Focus and commitment must be long term</td>
<td>Competing uses for available capital</td>
</tr>
<tr>
<td>Overcoming the learning curve</td>
<td>Accessing capital for competing needs</td>
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</tbody>
</table>
Captive Program Structures
Deductible Buy-back Captive Solutions

- **Transfer Program**
  - Carrier
  - Premium
  - Policy
  - Deductible

- **Captive Program**
  - Client
  - Premium & Capital
  - Policy
  - Reimbursements

- **Captive Program**

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*Source: Hylant Global Captive Solutions*
Fronted Reinsurance Captive

Admitted Fronting Insurer
Reinsurance cedes to captive

Captive
Captive retains risk at agreed level

Reinsurer
Captive retrocedes risk in excess of its desired retention

Owner/Insured
Fronting insurer issues policies, arranges claim-handling services

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Captive retrocedes risk in excess of its desired retention

Reinsurer
Captive retrocedes risk in excess of its desired retention

Captive retains risk at agreed level
Direct-Issue Captive

**Owner/Insured**
Captive insurer issues policies, arranges claim-handling services, retains risk at agreed level

**Captive**
Captive reinsures in excess of its desired retention

**Reinsurer**
Captive Evaluation
Captive Evaluation Process

- 01 -
Feasibility Analysis

- 02 -
Implementation

- 03 -
Captive Management
Feasibility Analysis

Evaluate
• Current exposures and future growth
• Coverage needs
• Cash-flow requirements
• Current program
• Service Providers

Analysis
• Domicile analysis
• Ownership and structure analysis
• Actuarial analysis
  • EXPECTED LOSSES + CAPITAL
  • CONFIDENCE INTERVAL FUNDING
  • EXPENSES

Considerations
• Investment considerations
• Regulatory and legal considerations
• Federal and state tax considerations
• Cost considerations

Implementation plan for execution
Implementation

Step 1: Decision to Proceed

Step 2: Select Service Provider(s)

Step 3: Develop Business Plan
- Meet Regulators/Board of Directors

Step 4: Submit Applications

Step 5: Capitalize
- Receive approval letter
- Commence underwriting

Step 6: Hold/Attend organizational meeting

Duration:
- 4 – 6 Weeks
- 4 – 6 Weeks
Case Study: Captives and Risk Management

• Need to address hospital and physician claims and risk management issues
  • Hospital self-insured
  • Physicians commercially insured
  • Claims management conflicts
  • Increasing cost of risk

• Captive insurance program for physicians and hospital
  • Fronted for compliance
  • Claims management control - Unified defense
  • Experienced rating (cost allocation) incentivized clinical risk management cooperation
  • Reduced cost of risk

• Excess of Liability Loss Coverage – access to reinsurance
  • Increased capacity
Case Study: Strategic Use of Captives

- Use of Franchisees to distribute product
- Strategic issues:
  - Supply Chain
  - Reputation
- Fronted captive insurance program to offer a third-party coverage for franchises
  - Truckers Liability
  - Inventory
  - General Liability
  - Manuscripted claims management and loss prevention programs
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