

# Captive Insurance

3

## Captive Insurance Company - What is it?

- A limited purpose, licensed insurance company, the main business purpose of which is to insure the risks of the captive's owners
- A risk assumption vehicle
- An insurance or reinsurance company
- Specifically established to insure or reinsure the risks of its parent, affiliated entities, and/or associated third parties

4

## Defining Characteristics of Captive Insurance:

- The captive's insureds (or persons affiliated with the insureds) provide the capital used to fund losses (more on this later), and ultimately benefit from any profits generated by the captive
- The captive operates outside the traditional regulated insurance market
- The captive is used to achieve the insured's risk financing objectives



Session 2, Slide 5

Introduction to Alternative Risk Financing Mechanisms

5

## Interactive Student Activity

Would you define “captive insurance” differently?

If so, how?



Session 2, Slide 6

Introduction to Alternative Risk Financing Mechanisms

6

## Structural, Financial, and Regulatory Issues

7

### Captive Company - Licensure and Regulation

Captives are licensed and regulated by governmental insurance regulatory agencies:

- In the U.S., captives are licensed under state law, very little federal regulation.
- Offshore, captives are generally licensed by a national governmental body



Session 2, Slide 8

Introduction to Alternative Risk Financing Mechanisms

8

## Captive Concepts

- Captive Utilization
- Captive Insurance Programs
- Captive Facilities

Session 2, Slide 11

Introduction to Alternative Risk Financing Mechanisms

11

## Captive Concepts - Utilization

Retained Risk Finance	Risk Transfer Rate Arbitrage	Access to Capacity	3rd Party Utilizations
<ul style="list-style-type: none"> <li>• Infrastructure for providing transparency, validation, and rationalization of retained risk positions</li> <li>• Enhancing risk management efforts</li> <li>• Accelerating tax treatment of deductible liabilities</li> </ul>	<ul style="list-style-type: none"> <li>• Reinsurance market cost of risk transfer is less than commercial retail cost of risk transfer</li> <li>• Better use of capital to retain risk than transfer it</li> <li>• Managing total cost of risk</li> </ul>	<ul style="list-style-type: none"> <li>• Federal programs (TRIA)</li> <li>• Reinsurance capacity, which may not be otherwise accessible in commercial retail market</li> <li>• Mutualization of risks across buyers</li> </ul>	<ul style="list-style-type: none"> <li>• Franchisee programs</li> <li>• Consumer facing insurance programs</li> <li>• Affiliate business</li> <li>• Agency captives</li> <li>• 3rd party business</li> <li>• Entrepreneurial initiatives</li> </ul>

Session 2, Slide 12

Introduction to Alternative Risk Financing Mechanisms

12

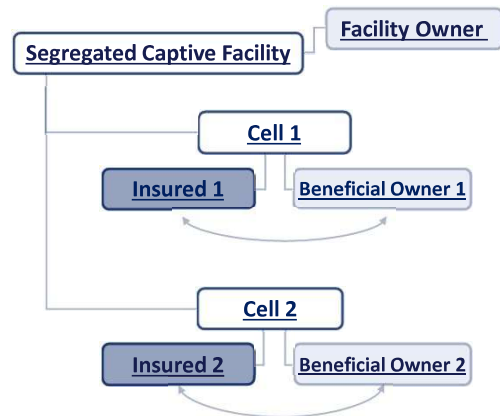
## Captive Concepts – Types of Facilities

### Equity Captive Facility



- Insured – pays premiums and submits claims
- Captive- pays operational service providers, collect premiums, pays claims, dividends profits
- Shareholder/Beneficial Owners– provides capital and surpluses, and collects dividends

### Segregated Captive Facility



Session 2, Slide 15

Introduction to Alternative Risk Financing Mechanisms

15

## Key Provisions of Insurance

- Indemnity for identified loss, in exchange for payment of a premium
- Coverage is commonly provided on an occurrence or claims made basis
- Insurer has limits of liability (i.e., doesn't pay claims forever)
  - per claim or occurrence
  - aggregate for all claims

Session 2, Slide 16

Introduction to Alternative Risk Financing Mechanisms

16

## Key Provisions of Insurance

- An insurer's most significant liability is for loss indemnity payments, for example:
  - the replacement cost of property damage
  - damages incurred by a third party as a result of the insured's professional negligence.
- An insurance policy may also provide coverage for costs related to a claim, otherwise known as "loss adjustment expenses" or "LAE", for example:
  - the costs of investigating and adjusting a property loss
  - cost of a legal defense to a professional liability claim

Session 2, Slide 17

Introduction to Alternative Risk Financing Mechanisms

17

## Captive Insurance Company: Potential Benefits

- Centralized risk management
- Cost efficiencies
- Provide coverage not available at reasonable rates or at any rate



Session 2, Slide 18

Introduction to Alternative Risk Financing Mechanisms

18

## Potential Benefits Cont.

- Benefit from captive's investment of capital and premium
- Access to reinsurance markets
- Possible federal income tax advantages in deduction of premium and loss reserves

Session 2, Slide 19

Introduction to Alternative Risk Financing Mechanisms

19

## Interactive Student Activity

What are some additional benefits you have experienced or witnessed from the use of a captive?



Session 2, Slide 20

Introduction to Alternative Risk Financing Mechanisms

20

## Forming a Captive: Key Considerations

- Choice of Domicile
- Type of Captive
- Legal Structure for the Captive
- Regulatory Compliance

Session 2, Slide 21

Introduction to Alternative Risk Financing Mechanisms

21

## Choice of Domicile Factors:

- required capital
- type of insurance business and ownership of the captive
- regulatory fees and domicile taxes
  - Regulatory fees & domicile premium taxes
- availability of qualified service providers
- subject business tax considerations (onshore versus offshore)
- domicile structural options

Session 2, Slide 22

Introduction to Alternative Risk Financing Mechanisms

22



## Regulatory Compliance in Domicile

- Basic Financial Concepts:
  - Capital
  - Reserves
  - Surplus

Session 2, Slide 27

Introduction to Alternative Risk Financing Mechanisms

27

## Regulatory Compliance in Domicile: Balance Sheet

### Sample Balance Sheet:

Assets	-	Reserves (liability)	=	Surplus (equity)
\$1,000,000	-	(\$ 650,000)	=	\$ 250,000 (minimum) \$ 50,000 (add'l capital) \$ 50,000 (accum. earn.)

Session 2, Slide 28

Introduction to Alternative Risk Financing Mechanisms

28

## Captive Insurance Risk Capital : Sources

- Primary sources of risk capital for insurance companies:
  - Core capital
  - Contributed surpluses
  - Premiums (minus losses)
  - Investment income

Session 2, Slide 29

Introduction to Alternative Risk Financing Mechanisms

29

## Capital and Surpluses

- Core Capital – provided by facility owner
- Surpluses – provided by the at-risk ‘beneficial owner’ of the captive insurance program
- Premiums paid by insureds
- Investment income – derives from all assets in captive
- Profits – inure to the at-risk ‘beneficial owner’ of the captive insurance program

Session 2, Slide 30

Introduction to Alternative Risk Financing Mechanisms

30

## Capital and Surpluses Chart

	Equity Captive			Segregated Captive	
Core Capital provided by	Captive Owner			Facility Owner	
	Single Parent Captive	Group Captive	Association Captive	Reinsurance Pooling	Agency Captive
Surpluses provided by	Parent	Members, usually related to insureds	Sponsoring Association	Pool Participants	Agent
Premium paid by	Parent, subsidiaries, affiliates etc.	Insureds	Members of the Association	Pool Participants	Customers
Investment income derives from	Surpluses, Premiums, and if an equity captive, Core Capital				
Profits inure to	Parent	Members	Sponsoring Association	Pool Participants	Agent

Session 2, Slide 31

Introduction to Alternative Risk Financing Mechanisms

31

## Questions

Type in your question in the Chat Box



Session 2, Slide 32

Introduction to Alternative Risk Financing Mechanisms

32

## Captive Insurance Company Regulatory Compliance in Domicile

- annual audited financial statements
- annual actuarial certification of loss reserves
- Investments
- annual meetings in place of domicile (exceptions since Covid)
- periodic examination of operations by domicile
- on-going oversight by domicile
- annual report (NAIC statement or variation thereof)
- filing and approval of business plan changes

Session 2, Slide 33

Introduction to Alternative Risk Financing Mechanisms

33

## Interactive Student Activity

### **Recap:** Key Considerations in Forming a Captive

- What other factors would you consider in forming a captive?

Session 2, Slide 34

Introduction to Alternative Risk Financing Mechanisms

34