How Reinsurance Works in Captives

Captives and Reinsurers – Working Together

One of the key benefits from owning a captive is access to the reinsurance markets as viable alternative to the retail commercial insurance markets.

A captive can underwrite almost every line of business available from the retail commercial market and can also provide specialized coverage for unusual or hard-to-place insurance risks. These non-traditional risks may be mitigated by working with the more sophisticated reinsurance markets, which have a broader appetite for such risks when compared to the retail market.

As a result, there has developed a partnership between captives and reinsurers in which unusual risks are "incubated" in a captive, while being supported in large part by the reinsurance industry as the risk's experience develops. We can cite examples such as mold insurance or cyber risks when they were originally first introduced.

To Reinsure or Not to Reinsure – That is the Question!

When first contemplating the formation of a new captive -- as well as for its subsequent years of operation -- the decision on whether to buy reinsurance is a fundamental question for the Parent company to ask and answer.

The decisions surrounding the purchase of reinsurance behind a captive are quite involved and need a lot of thought to ensure that the optimum program is created to protect the captive.

The range of options may go from the blanket whole account or basket aggregated reinsurance -- which accesses reissuance for all lines combined – to a more complex web of inter-connected reinsurance contracts all working together to provide protection on a per risk, per catastrophe and per annual aggregate basis.

They key considerations will be:

- Why does the captive need reinsurance?
    - Inadequate initial capital;
    - Highly volatile risk;
    - Risk appetite of the Parent dictates more prudence, etc.
- How much risk should the captive retain and how much to cede
- The price of the reinsurance
- The quality of the reinsurer
- What is the best type of reinsurance to buy?
    - Facultative
    - Treaty
        - Proportional
        - Excess of Loss
- Whether to use the services of a professional reinsurance intermediary
- Will the reinsurer be able to assist the captive grow its business and be a true partner to deal with unforeseen obstacles and challenges.

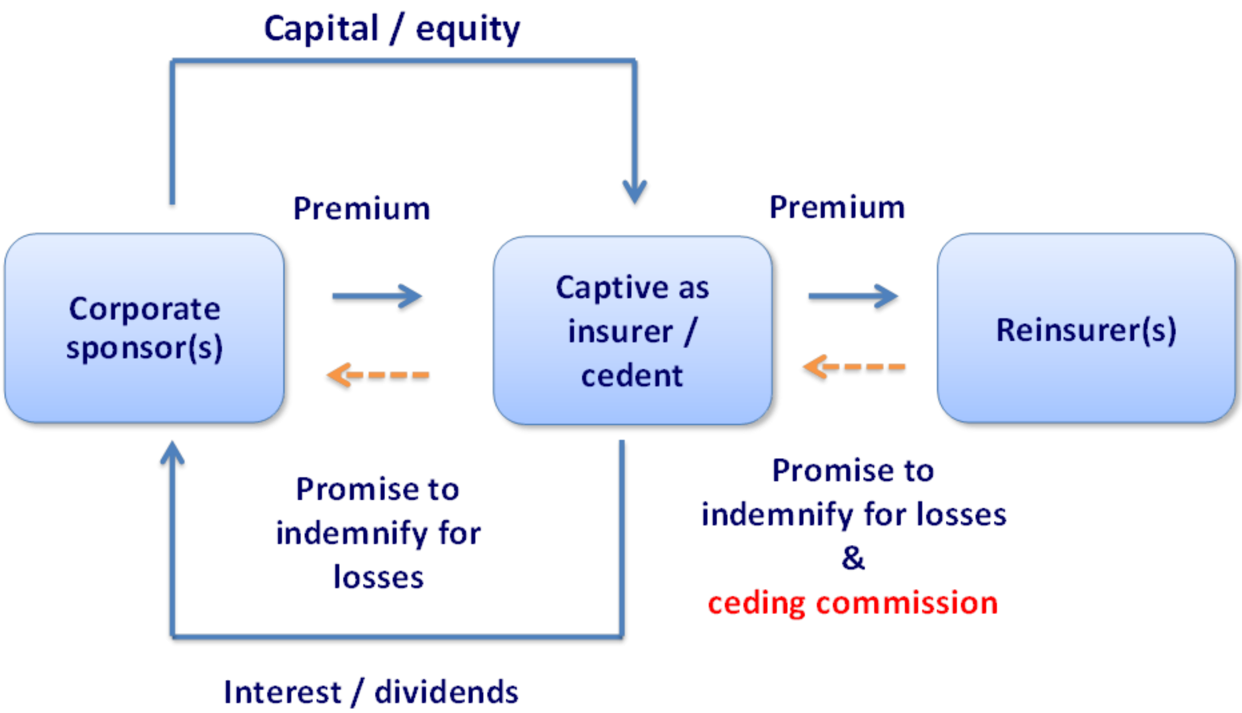
Captive Reinsurance – Similar but Different!

The reinsurance transaction between captive and reinsurer is generally the same as it would be for any other insurance company seeking to reinsure its risk. There are, however, a few differences in reinsurance when a captive is involved.

1.) The Captive as the Insurer and Cedent

The diagram below shows the contractual relationships between the three parties of the Parent / Corporate Sponsor ("Parent") of the captive as the insured, the captive as the insurer and then the reinsurer.

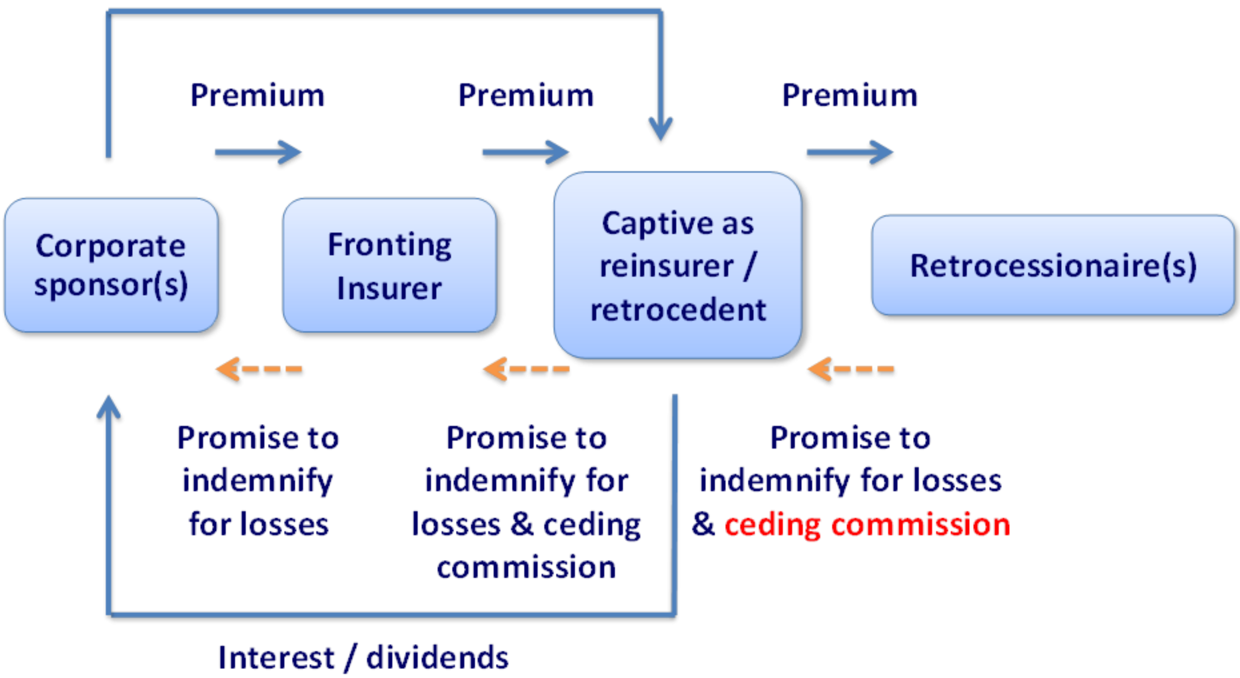
There is a policy of insurance between the Parent and the captive and a contract of reinsurance between the captive and the reinsurer.



This reinsurance structure is used where the captive is able to directly issue insurance policies to its Parent without the need for an unaffiliated insurance company, known as a fronting company, to first issue a policy to comply with regulatory or other stakeholder requirements. Examples of this direct relationship would be for deductible reimbursement policies and property insurance where there is no requirement for the insurance to be provided by a well know insurer or an insurer that carries a certain minimum A.M. Best's rating.

2.) The Captive as the Reinsurer and Retrocedent

For those risks requiring licensed paper fronting -- the route to access the ultimate reinsurance market -- becomes longer. As shown in the diagram below, the fronting carrier is the primary insurer of the Parent. The fronting carrier then reinsures the risk into the captive, which in turn retrocedes the risk to the retrocession (reinsurance or reinsurance!) markets.



Examples of a fronting carrier used as part of the chain to access reinsurance would include any compulsory lines of cover (Auto or Workers Compensation), property insurance for which a mortgage holder or bank requires insurance from a licensed insurer with a minimum A.M. Best's rating, General Liability, and for group captive programs.

Specific Mechanics of a Captive Reinsurance Transaction

Ceding Commission

As displayed in the two preceding diagrams, the reinsurer or retrocessionaire often agrees to pay to the captive a Ceding Commission as part of the transaction. A Ceding Commission is a commission payable usually as a percentage of the premium received by the reinsurer / retrocessionaire. It is designed to cover the administrative costs and acquisition expenses incurred by the cedent and is more common in proportional reinsurances than in excess of loss contracts. The size of the commission can vary according to overall desirability of the risk being assumed by the reinsurer/ retrocessionaire. The range can be wide -- from 5% up to 30% in some instances.

Facultative or Treaty Basis

The process of Reinsuring a captive borrows heavily from the placement of reinsurance on a facultative basis. The contract is between the captive insurer and the reinsurer and tends to be for a particular risk, such as the Workers Compensation, General Liability or the Property exposures of the Parent company. The exception to this would be where the reinsurance contract is for the entire portfolio of risk as may be found under a whole account reinsurance covering a basket aggregate for a wide range of insurance lines. These forms of reinsurance are more akin to treaty reinsurance placements.

Direct Placement or Placement Through a Reinsurance Intermediary

The International Association of Insurance Supervisors ("IAIS") defines a captive as "an insurance or reinsurance entity created and owned, directly or indirectly, by one or more industrial, commercial or financial entities, other than an insurance or reinsurance group entity, the purpose of which is to provide insurance or reinsurance cover for risks of the entity or entities to which it belongs, or for entities connected to those entities, and only a small part if any of its risk exposure is related to providing insurance or reinsurance to other parties."

From this definition we can say that captives are formed by Parent companies who are experienced managers of risk and are deemed to be more sophisticated than retail insurance customers. The reinsurance contract is between and insurance company and a reinsurer. It is true that both parties still deal with each other as equals in the negotiation of the contract, but it is fair to say that the reinsurers will have more of an advantage over the captive when it comes to the day-to-day operations of insurance enterprises.

While the use of a reinsurance intermediary is not essential, it is good practice for the captive as cedent to use the services of a qualified reinsurance intermediary. This will provide the captive as cedent with the best advice available to negotiate a fair and reasonable reinsurance contract that is up to date with current market developments.

Conclusion

The development and purchase of a captive reinsurance program requires a good deal of expertise and input from the captive's parent and external advisors. The programs are definitely not "set and forget" and once the program has been put in place, it should also be monitored to ensure it is providing the cover required.

Few decisions regarding the use of a captive are more important than the structure, quality and collectability of a captive's reinsurance program. Unless the Parent is well versed in the vagaries of the reinsurance market, it is advisable to obtain expert advice from reinsurance intermediaries on the best approach to follow.

Captive Insurance

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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

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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

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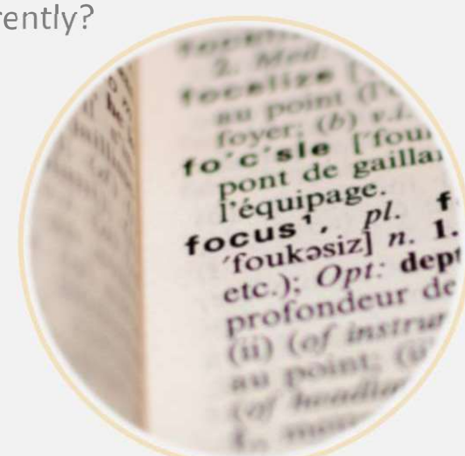
Interactive Student Activity

Would you define "captive insurance" differently?

If so, how?



Session 2, Slide 6

Introduction to Alternative Risk Financing Mechanisms

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Structural, Financial, and Regulatory Issues

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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

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Captive Concepts

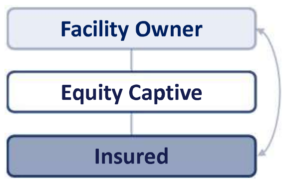
- Captive Utilization
- Captive Insurance Programs
- Captive Facilities

Captive Concepts - Utilization

Retained Risk Finance	Risk Transfer Rate Arbitrage	Access to Capacity	3rd Party Utilizations
• Infrastructure for providing transparency, validation, and rationalization of retained risk positions • Enhancing risk management efforts • Accelerating tax treatment of deductible liabilities	• Reinsurance market cost of risk transfer is less than commercial retail cost of risk transfer • Better use of capital to retain risk than transfer it • Managing total cost of risk	• Federal programs (TRIA) • Reinsurance capacity, which may not be otherwise accessible in commercial retail market • Mutualization of risks across buyers	• Franchisee programs • Consumer facing insurance programs • Affiliate business • Agency captives • 3rd party business • Entrepreneurial initiatives

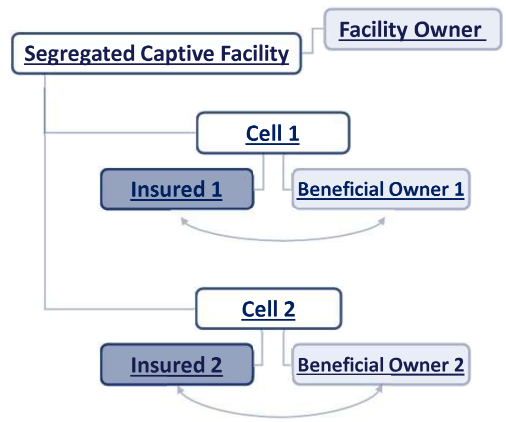
Captive Concepts – Types of Facilities

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



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

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

Captive Insurance Company: Potential Benefits

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

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

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Interactive Student Activity

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

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Forming a Captive: Key Considerations

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

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

Regulatory Compliance in Domicile

- Basic Financial Concepts:
  - Capital
  - Reserves
  - Surplus

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.)

Captive Insurance Risk Capital : Sources

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

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

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

Questions

Type in your question in the Chat Box

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

Interactive Student Activity

Recap: Key Considerations in Forming a Captive

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

For decades, large corporations around the world have enjoyed the many benefits of operating their own captive insurance company. Most were established to provide coverage where insurance was unavailable or unreasonably priced. These insurance subsidiaries or affiliates were often domiciled offshore, especially in Bermuda or the Cayman Islands. The risk management benefits of these captives were primary, but their efficient tax and operating advantages were also important.

In recent years, mid-sized, closely held businesses have also learned that the captive insurance entities can provide them significant benefits. These include the attractive risk management elements long appreciated by the larger companies, as well as some attractive opportunities. A properly structured and managed captive insurance company is all about control and, properly structured for the right reasons, could provide the following benefits:

- Retain premiums otherwise paid for commercial insurance
- Design coverage for gaps and/or egregious terms typically found in commercial policies (i.e. property retentions; wage/hour coverage; product recall)
- Direct access to the lower-cost reinsurance market
- Use higher retentions to drive market pricing (reduce dependence on commercial market)
- Ability to manage claims yourself, not rely on the insurance company's incentives to settle claims
- Keep underwriting profits and investment income on funds held
- Profit center to manage customer risk (provide warranties, weather insurance; guarantees)
- Use equity for dividend potential (or invest in expansion of your business, shareholders)
- Efficient tax treatment of underwriting profits, when it makes sense
- A vehicle to manage compliance and risk appetite across the organization

There are many types of captives for a multitude of purposes. For example, these include "pure captives," where the insurance company only insures the risks of the owner and related entities; "group captives," where the captive insures the risks of the shareholder/members of the captive; and "agency captives," where the captive is owned and operated by one group (insurance agents) to insure the risks of their related clients.

IDEAL CANDIDATES FOR CAPTIVES

Single parent captive should be considered for entities that meet the following criteria:

- Entrepreneurial business entities seeking control over their insurance future
- Historically favorable loss experience (loss ratio less than 50% of premiums paid over 5-years)
- Businesses with diverse risk exposures or high risk needing customized solutions
- Commercial insurance premiums typically exceed $1MM annually
- Owners who can commit to a long-term strategic play
- Management is committed to safety, risk management, and loss control
- Business with a problem to solve: extended warranties; customer billings; high retentions

INSURANCE REQUIREMENTS

There are some captive promoters that historically "sold" captives exclusively for the tax benefits alone. The IRS will not tolerate this structure and mandates that the captive must be established for legitimate insurance purposes. We are risk management and insurance-focused, not tax, so while being tax efficient is important, it's not the focus of a captive and never should be.

Sufficient for this paper is to state that for a captive to qualify as a valid insurance company, it must at least insure legitimate business risks, operate in way that insurance companies would generally operate, and have the elements of risk shifting and risk distribution. We are happy to continue the discussion, but if "tax benefit" is the first objective on your list of captive benefits, we are likely not the right fit as your consultant.

FORMATION OF A CAPTIVE

The formation of a captive insurance company is a detailed process including feasibility studies, financial projections, determining domicile, and, finally, preparing and submitting the application for an insurance license.

The need for a qualified captive manager on the planning team is very important, particularly in the formative stages.

One critical function to be performed during the formative stages is the identification of the risks to be insured by the captive. We call this process, "CORE™ Review" (Coordinated Overview of Risk and Exposure). We identify your current gaps and operational exposures, then blend them with outside actuary and risk management recommendations. The operating company is presently paying premiums to one or more commercial insurance companies to protect it from specific risks, some of which could be catastrophic if they were to occur without such insurance. The goal of a captive would be to maintain the transfer of the catastrophic risks to the commercial carriers, but to assume the underwriting and premiums associated with more "manageable" risks.

The policies that are written need to be for "real" insurance risks, not ones that will never occur. Should the captive see a need to protect itself in the case of a higher-risk policy, it may be able to buy reinsurance at premiums that are less than the premiums that it has charged the parent company.

One of the key risk management benefits that the captive will provide is the flexibility to opt for higher deductible levels on the existing property and casualty (or health) insurance policies. This obviously helps drive deep discounts in your commercial premium.

Another area for consideration is the requirement for adequate initial capitalization. This will be dependent in part on the level of risk projected to be assumed by the captive and the requirements of the respective domicile chosen. In some cases, this initial capitalization can be accomplished using irrevocable letters of credit.

OPERATION OF THE CAPTIVE

The use of an experienced and capable Captive Manager is an essential element of the normal operations of a regulated and board governed entity. If a fronting carrier is necessary to pass the premiums along to the captive, then a Program Manager will be key to structuring and maintaining this relationship. Elevate serves both as a Captive Manager and Program Manager.

The need for annual actuarial reviews, annual financial statement audits, continuing governance compliance oversight, claims management, and other regulatory compliance needs puts the day-to-day management of a captive insurance company beyond the skills of most general businesspeople. Likewise, the oversight of the management company in the investment activities of the captive is essential from a planning perspective to assure that the captive's liquidity needs are met.

SUMMARY

You no longer must solely rely on commercial insurance to fund for risk and uncertainty. By creating and owning your own captive, you can finally take the ultimate control in your own risk-financing destiny and enjoy the benefits that the vast majority of the Fortune 500 companies have been taking advantage of for decades.

Benefits	Savings	Cautions
Greater control of insurance Manuscript insurance terms Less dependence on insurance mkt. Experienced claims managers Leverage buy excess limits Share knowledge Improved cash flow	Pay only your group's losses Lower administrative expenses Keep profits & investment income Receive dividends Lower claim payouts with experienced adjusters	Long-term commitment Capital outlay at the start Sharing results of members Finding like-minded business owners

Elevate provides turn-key design/build solutions, and operates your captive insurance company, with full transparency and accountable to you. We are captive insurance experts, so you don't have to be.

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Ryan is an experienced industry leader in risk management and insurance. He is a past Director of Risk Management at Whirlpool Corporation and as Risk Manager at Koch Industries, The Boeing Company. Ryan has lead organizations to develop and implement global risk management strategies, including the placement of insurance, negotiation and interpretation of coverage, self-insurance analysis, enterprise risk management process, claim management, actuarial reserve analysis and accounting impact, captive set-up and management, and broker relations. Ryan has participated on due diligence teams and with the integration of major acquisitions. He has been a frequent speaker at RIMS and CICA for risk management, captives, and leadership topics.

Captives by State, 2022-2023

Rank	Domicile	20	20
1	Vermont	639	659
2	Utah	412 (1)	439
3	North Carolina	294	311
4	Delaware	319 (1)	289
5	Hawaii	255	263
6	South Carolina	209 (1)	221
7	Arizona	162	176
8	Tennessee	150	162
9	District of Columbia	113	120
10	Montana	101	100
10	Nevada	155	100
12	Texas	72 (1)	79
13	Georgia	56	57
14	Oklahoma	45 (1)	56
15	Missouri	54	55
16	Alabama	51	54
17	Connecticut	45	53
18	New York	39 (2)	37 (1)
19	Kentucky	32	32
20	Michigan	24	26
21	New Jersey	20 (1)	20 (1)
22	Arkansas	15	16
23	South Dakota	14	15
24	Ohio	7	8
25	Colorado	6	6
26	Nebraska	4	4
27	Maine	3	3
28	Illinois	2	2
29	**Kansas**	**1**	**1**
29	West Virginia	1	1
	United States (3)	**3,300**	**3,365**

(1) Restated. (2) Business Insurance estimate. (3) Excludes territories.

Source: Business Insurance Survey, Business Insurance, April 2024.