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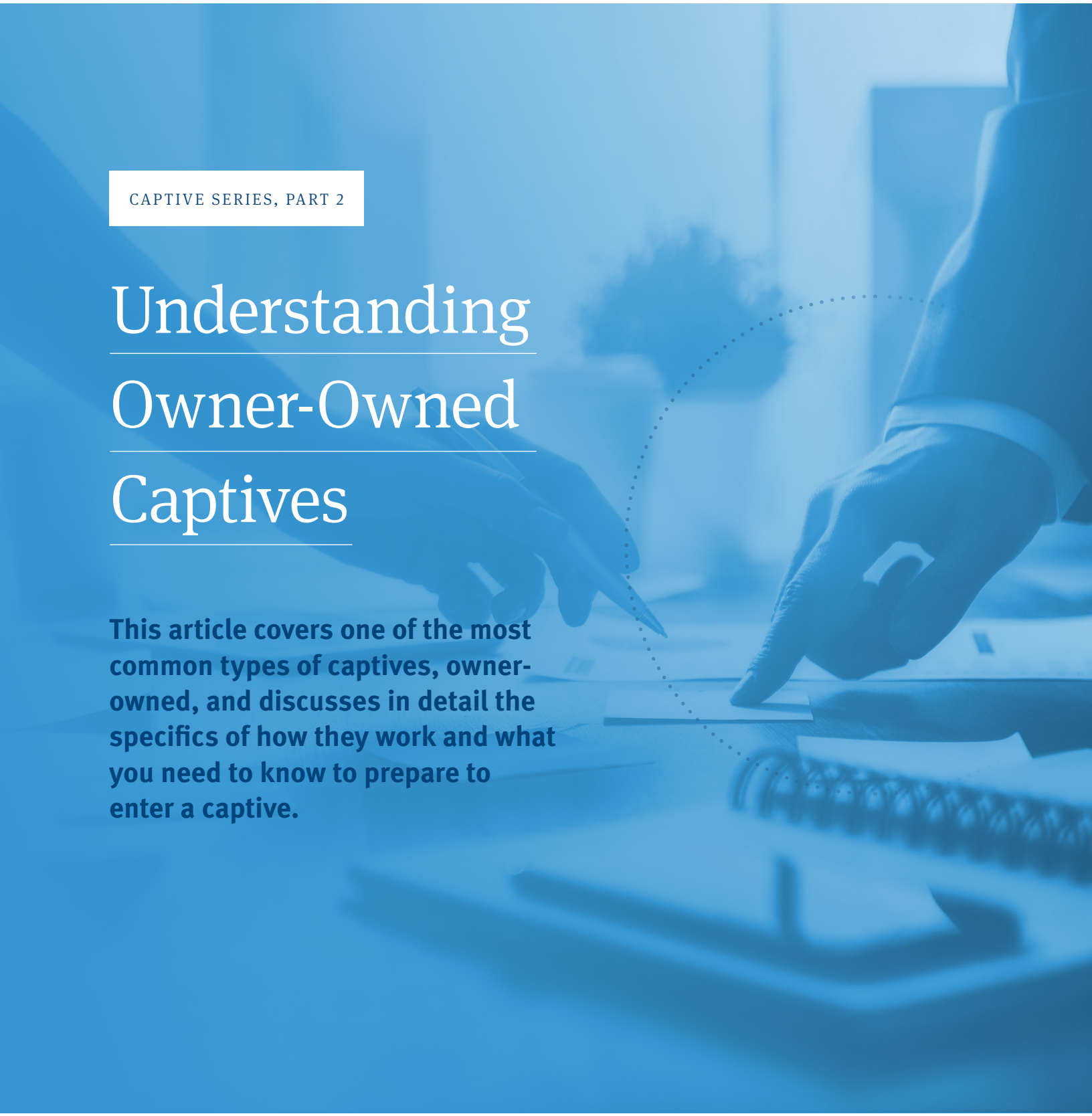
CAPTIVE SERIES, PART 2

Understanding Owner-Owned Captives



This article covers one of the most common types of captives, owner-owned, and discusses in detail the specifics of how they work and what you need to know to prepare to enter a captive.

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When an organization is considering the possibility of entering a captive, some of the likely reasons might include premium costs, the company's own safety record, and a need to have much more control and/or flexibility over the financial aspects of their insurance costs. Once an organization has made the decision to go the captive route, however, they will head full speed directly into the center of the insurance world. They have spent their time on the client side of the insurance world, but now they will be entering into areas that clients do not normally see. They will see some of the underwriting aspects; they will see what a reinsurer does; and they will work with actuarial firms, loss prevention service providers, and third-party claims management services.

Let's look at a fictitious owner-owned captive that is relatively close to what we might expect to see out in the real world. When the decision is made to enter the captive, the mindset of ownership should shift from the existing risk transfer model (the typical purchase of insurance on the open market) to a risk financing/risk control model. So, when the owner-owned captive model is selected by the business owner, the owner will become a fractional owner of an insurance company, and therefore must begin to think not like a customer of insurance services, but like someone who is responsible for the company's loss results.

Now it's time to give our fictitious captive some structure and context. Let's imagine our captive is an owner-owned, homogeneous captive that is focused on the needs of construction subcontractors who have a minimum premium size of $100,000. Once a company "buys" into a captive with their premium, they become a member and an equal shareholder of the captive, regardless of the size of the premium they pay. This means that every member of the captive has an equal say in its direction and strategies. A simple majority of the executive board will govern the decisions made and the course the captive will take.

This particular captive would be based offshore as many of these types are. The Cayman Islands are a good choice because there is already an extensive infrastructure in place as the Caymans are the second most popular choice for owner-owned captives to be domiciled.[1] When a new member/owner buys into the captive, they will also strongly be encouraged to participate fully in the operations and help guide the captive's direction. Typically, the new member will be assigned or will choose to be involved in one of the executive board's subcommittees which will meet during the biannual captive board meeting that must be held outside the United States.

There are many variations of the structure of these captives depending on what the executive board finds most important. For our example, we have one executive board and three subcommittees: underwriting, risk control, and investment/finance. One item of note: every member/owner of the captive will typically be a member of one of the three subcommittees or the executive board. It is expected that all members rotate through the subcommittees and the executive

board as to get as much experience and input as possible from the members themselves, which will create better, more global decision-making.

The underwriting committee advises the board on desirable risk levels and ensures that potential members are underwritten adequately. The risk control committee helps the board set benchmarks for the members' safety and loss prevention efforts, reviews loss control results, and works with the board to help members meet their loss control goals. The finance and investment committee advises the board on investment policies and reviews annual audited financial statements. As you can see, when a company becomes a member of a captive, the captive becomes a vehicle that is being driven by the members, not a third party whose interests might not be in alignment with each individual organization.

Captive board meetings are typically held twice per year and must be conducted offshore, if that is where the captive is domiciled. Captive insurance companies were once viewed as insurance vehicles best domiciled offshore, generally. Recently, however, there have been changes in some state laws that removed some of the tax and flexibility obstacles that historically prevented a domestic choice to be made.[2] In our fictional case, we will suppose that the founders of the captive determined that the benefits of domiciling the captive in the Cayman Islands outweighed the detriments.

These captives will have to hire support professionals to conduct the day-to-day operations of the captive. These professionals help create overall structure of the captive and are ultimately responsible directly to the board of directors. Of course, these organizations do not work for nothing. Their costs will be worked into the fixed costs each member will pay to the captive as part of their premium every year. The following are a list of typical service professionals that are employed to meet the needs of the captive's day-to-day operations, (at least here in our fictitious example).

Captive Consulting Firm

The captive consulting firm is responsible to the board to see that all of the decisions of the board are carried out. The firm is involved as a nonvoting member in all of the executive meetings. The captive consulting firm also takes a large part in planning of the board meetings, workshops, and seminars.

Captive Insurance Brokers

The captive insurance brokers are responsible for all of the insurance aspects of the program. This would include items such as coordination of policy issuance, billing, collection, and certificates of insurance. The brokers are also responsible for bringing new business to the captive.

Captive Insurance Manager

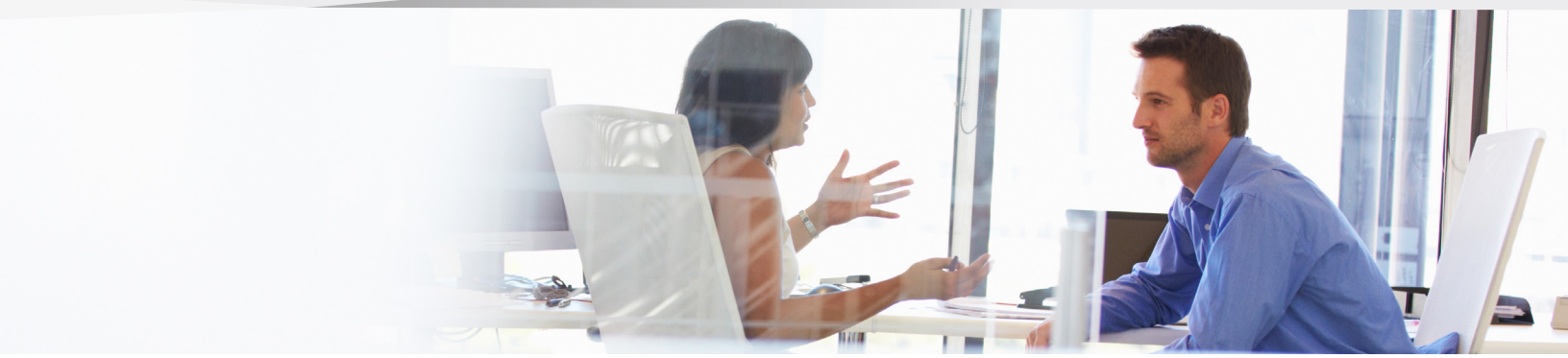
The captive insurance manager is responsible for managing the day-to-day operations of the captive, and therefore, in this example would be located in the Cayman Islands. The day-to-day operations includes items such as financial accounting for all transactions, maintaining corporate and statutory records, and advising the board on any fiscal or offshore insurance developments.

Captive Program Insurance Company

This company issues the actual policies that will insure the shareholders of the captive, also sometimes referred to as the fronting carrier. This company will cover the legal requirements of providing insurance for the shareholders. As far as anyone receiving insurance documents will know, the member company will appear to be insured by the fronting carrier.

Captive Specific Excess Reinsurer

This organization will provide a large loss layer that the members are not willing to retain. They will receive a premium for this coverage and will pay all losses within that layer.



Captive Actuarial Firm

This firm will take loss data provided by the shareholders and brokers and will set a loss projection for each of the members. The final premium for the members will be based on this loss projection.

Captive Claims Administration Service

This organization will manage and settle all claims made against the shareholders based on a set of instructions set forth by the executive board. The captive consultant will assign a claims manager to work with the claims administration service to coordinate compliance with instructions set forth by the board and will report to the board at the biannual board meetings.

Captive Loss Prevention Service Provider

The captive loss prevention service provider is responsible for providing loss control consulting services for the members. In addition, they will research, analyze, and report loss effort results to the captive program consultant, who will in turn report these results to the board at the biannual board meetings.

Captive Auditors

Captive auditors are responsible for auditing the financial reports prepared by the captive insurance manager.

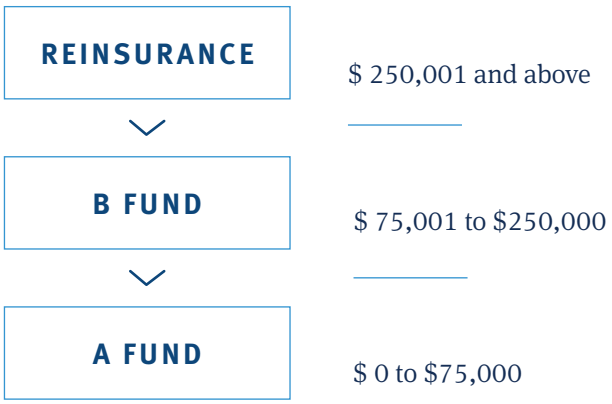
Now that we have the overall structure of the captive and the players within that structure, let's talk about the process of a normal year in a captive. A new captive member will have the actuarial firm doing analysis of the historical losses and come up with an estimate of expected losses, as would be done in the standard market. Since this member is brand-new, the captive needs to protect itself from this new member defaulting (going bankrupt or otherwise not being able to fund its premium and pay for losses they have obligated the captive to pay).

In addition to extensive financial qualifications for entry into the captive, captives typically will require collateral from the new member. Not only does this collateral insulate the other members from loss, but it also shows existing members that the new member is committed to the process and will not leave if there is a lower premium quoted down the line. This usually takes the form of a letter of credit or cash paid in over time. Then, the loss funds as well as the fixed costs needed to run the day-to-day operations of the captive are bundled together and paid as the company's insurance premium. A "loss fund to fixed cost" ratio can vary depending on the size of the company and, ultimately, the size of the premium given to the captive. The larger the organization, though, the lower the ratio of loss funds to fixed costs will be. For our example we will use 70% : 30%.

Once the premium has been paid, the loss fund dollars are then placed in two separate and distinct funds. We will call them the "A" fund and the "B" fund for our purposes. The "A" fund is used strictly to pay all of the losses under a certain dollar amount. The intent is for this fund to take care of the frequency layer of the losses, and it makes up the majority of the funds available to pay losses. Again, the details can vary from captive to captive,

but in our fictitious captive, let's say that the "A" fund will pay for all losses under $75,000 per occurrence. The "B" fund, as you might have surmised, will pay for losses whose costs fall between the top of the "A" fund, and the lower limit of the reinsurance layer. This is intended to take care of the more severe losses, also known as the "shock" loss layer. Above this layer is reinsurance to cover any losses over what the captive has retained.

FIGURE 1.

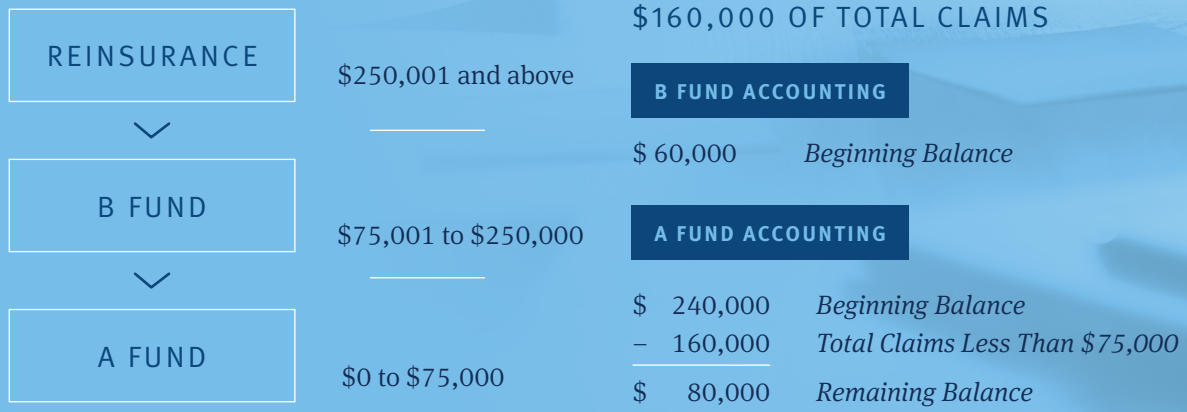


The trick here is this layer of coverage is shared among all of the other members of the captive, once the member has exhausted all of his available loss funds. The breakdown of how much of the total loss funds are allocated to each fund can vary from captive to captive, but in our example the ratio would be approximately 80% in the "A" fund and 20% in the "B" fund. (FIGURE 1.)

This may leave you questioning "if the largest losses will hit the "B" fund, why isn't the "B" fund the larger of the two, instead of the smallest?" This is a good and logical question. The answer is twofold. First, if the member is preventing losses as they are supposed to, the shock layer should never be hit, and the "A" fund will pay the expected small incidents that are likely to occur as the system is intended. Second, if a large loss occurs, the way the loss is paid from the member's loss fund makes much more than simply the small 20% available to pay the loss. The term "forgive for frequency, penalize for severity" comes into play here, and there are tools the captive uses to not only pay the claim but also hold the member company accountable for having the large loss, which we will cover in one of the upcoming scenarios. (FIGURE 2.)

FIGURE 2. PREMIUM DISTRIBUTION INTO FUNDS:

FIGURE 3.



Now that we have established what the fund looks like, let's discuss some of the scenarios of how the funds will be allocated in years with different results. We will look at a good year with some smaller claims and a year with some smaller claims and a catastrophic claims.

First, the good year with some smaller claims that doesn't hit the maximum amount in the "A" fund. As can be seen in figure 3, the company had $160,000 in losses under $75,000 per claim. That means all of those claims will be paid out of the $240,000 set aside in the "A" fund, leaving a remaining balance of $80,000.

That is it, and the year is closed out with $80,000 in the "A" fund and still $60,000 in the "B" fund for a total remaining loss fund of $140,000. When the year is closed out, your next question might be "so what happens to the $140,000?" The answer is relatively simple. The board will vote every year on when to pay dividends to all of the members from their loss funds, and typically there is a two- to four-year lag. In the case above, the claims that amounted to $160,000 all don't simply close out in a year. They develop over time and some have more money paid out, and maybe some have been able to get some sort of recovery, but after some time, any open claims are bundled up and the remaining claims are sold off. This is commonly referred to as the "tail." In the meantime, the loss funds are sitting in an interest-earning account, such as a mutual fund, and will continue to accrue interest and pay out on the open claims.

In this example, the year closed out with $140,000 remaining in the loss fund, and over the next two to four years the claims might cost another $20,000 in legal fees, remaining medical, and other claim-related costs. While these costs are being paid, the fund will also earn, for example, a 5% return. This means that when the board votes to issue a dividend, the company could receive as much as $142,068 ($140,000 + 5% over three years, minus $20,000 in costs, which could all vary depending on variable rate of return and when the costs actually hit the fund in the accounting cycle). Three years after the company closed out the year, they would receive a check from the captive as a dividend in the amount of $142,068. Not bad after having a year where they generated $160,000 of injuries.

Next, we will take a look at a year that didn't go so well for the organization. We will use the same company and losses as the previous example, but in this case we will add one more catastrophic loss of $1 million. Now, things get a little tricky and this is when the result

might not make the company so happy. We have the same cost distribution as before, but let's start with the large loss amount. Of the million dollar loss, the captive will only be responsible for the first $250,000; the rest will hit the reinsurance layer (which of course will affect pricing in the future, but that is another article). As can be seen in figure 4 on the next page, the $60,000 in the "B" fund will be used first. Then, anything left in the "A" fund will be used. (In our example, we are assuming the catastrophic loss was the last loss. In the real world, these losses are fluid as time goes by). After the small losses amounting to $160,000 are taken from the "A" fund, the amount remaining is $80,000. The remaining "A" fund dollars are then taken to pay the catastrophic claim.

If you do the math, the "B" fund, ($60,000) plus the "A" fund ($80,000) gives you $140,000. That is short of the $250,000 obligation for the million dollar loss. Where does the rest of the $110,000 come from? These funds are a shared obligation cost among all of the other members. The cost is spread out among all of the other companies according to the size of their overall loss funds as a percentage of the whole. For example, if another company in the captive has a loss fund that amounts to 2% of the overall captive loss fund (all of the companies loss funds combined) then they would be responsible for paying 2% of the shared obligation of $110,000, or $2,200. That takes care of the obligation for the catastrophic loss and the frequency loss for the year.

That doesn't mean that it is over for the company. Losses don't all occur on one day – they occur over time. As these losses happen, loss funds need to be made available for the continuing management of loss costs. When a fund is depleted, the company will have to reconstitute the fund. This could be done through an assessment of, in this case, another "A" and "B" fund. This has to be done to continue to pay for the losses throughout the year, and through the tail until it is sold. Other situations may only require partial reconstitution, but there must be funds available. This is primarily why safety and loss prevention is so important when managing losses in a captive. The company is directly accountable for all of the losses.

There are many other examples that we could go through, but these two provide enough of an explanation so the theory of the captive operation should be evident. After reading this explanation (albeit elementary and not really a deep dive into all of the details) the reader might be thinking, "Wow, that is a complicated system that requires much more participation than exists in the standard market. Why would I bother getting involved?" Again, great question. Captives are an alternative risk management tool that is not for everyone. The primary benefit a captive will provide an organization would be control over their loss dollars. This control will give the company an opportunity to recoup loss dollars that would normally go to finance the poor risk management practices of other companies

FIGURE 4

REINSURANCE	$250,001 and above
B FUND	$75,001 to $250,000
A FUND	$ 0 to $75,000

$160,000 OF TOTAL CLAIMS LESS THAN $75,000 AND A $1,000,000 CATASTROPHIC CLAIM.

B FUND ACCOUNTING

$	60,000	*Beginning Balance*
–	60,000	
$	0	*Remaining Balance*

A FUND ACCOUNTING

$	240,000	*Beginning Balance*
–	160,000	*Total Claims < $75,000*
–	75,000	*1st $75,000 of Cat. Loss*
$	5,000	*New Balance*
–	5,000	*Additional for Cat. Loss*
$	0	*Ending Balance*

CATASTROPHIC CLAIM

$	175,000	
–	60,000	
$	115,000	
–	5,000	
	$110,000	*Shared by all members' B Funds*

$	250,000	*Reinsurance Cap*
–	75,000	
$	175,000	*1st $75k from A Funds*

in the standard market. If an organization does a very good job managing their risk, has a good safety program, and is financially stable, a captive might just be a good alternative if management can commit to managing the program and will continue the good safety practices that minimize risk. If an organization is not interested in managing their losses but has a good safety record, this might not be the right program because eventually, due to the law of large numbers, a catastrophic loss will occur and will actually cost the company more than the regular premium. It is an important decision not to be taken lightly, but if the correct analysis is done, and an organization is suited well, they could reap extremely beneficial returns in the long run.

To view part 1 of our captive article series, visit **news.leavitt.com/business/understanding-captives**

REFERENCES

[1] *https://en.wikipedia.org/wiki/Cayman_Islands*

[2] *http://www.americanbar.org/publications/blt/2014/02/03_sheridan.html*

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