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Pooling in Microcaptives

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#WorldCaptiveForum

Pooling in Small Captives

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AGENDA

- How and why a small captive works
- Best practices for small captives
- Pooling – preliminary comments and IRS approach
- Pooling – some details
- Best practices for pools
- Avrahami – pooling and pricing
- Other pooling aspects -- low losses, poor allocations, etc.

"**risk pool**: Multiple subjects of insurance insured or reinsured by a single insurer, where to avoid risk concentration and improve risk distribution, different combinations of exposures, perils, and hazards will be underwritten."

Captives and the Management of Risk, IRMI, 2nd Edition, pg. 212

The SPINX Company

Year One and Lessons Learned

- Established in 1972 by Stewart Spinks
- Operates more than 80 convenience and gas retail stores throughout South Carolina
- Employs more than 1,200 associates
- Largest privately-held retailer in S.C.
- Major community supporter through various partnerships with local organizations and events
- Driven by five core values: Customer Focused, Team Oriented, Committed to Quality, Accountable, Passionate and Community Centric

Why did Spinx consider Captives as an alternative risk method?

- In 2016 our organizations growth had reached a point that the typical commercial policies needed to be reevaluated.
  - Broaden our options in managing and funding our business risk from an enterprise risk management perspective.
  - Design policies to fit within the total Enterprise Risk Management Program
  - Enhance our existing claims management program
  - Quantify exposures as a low frequency and low severity type risk

First year lessons learned

- With over 20 years of commercial insurance experience and 10 years of enterprise risk management including self funded and self administered programs. What did the first year's journey in a new captive teach us?
  - Policies – The Captive Feasibility Study that was done was very in-depth and comprehensive and allowed for a set of policies that strengthen, and closed some of the exclusions in the current commercial policies.
  - Claims – The Captive impowered us with the ability to select and process claims that tied back into the organizational objectives.   This management tool is seen as a huge benefit.

Does your Risk Manager's job change in a captive?

- Yes, at its simplest foundation:
  - A risk manager's job is to develop and design programs that protect the organizational assets (financial, human, property, etc.).

How It Changes:

  - Risk Managers in commercial insurance will submit claims to the carrier, who sets the reserve and manages the claims process.
  - Risk Managers In captive insurance are involved more in the claims process and should have some comfort level or experience in setting reserves and proper claims management techniques.

  - The risk manager is also more involved and engaged in the exposure review, policy development and having the ability to work with underwriters and reinsurers to make sure that opportunities aren't missed.

How does a Risk Manager balance commercial and captive policies?

- Both type of policies have value for a risk manager and for an enterprise risk management program.

  Almost all commercial policies have exclusions built into them.

  - An **exclusion** is a policy provision that eliminates coverage for some type of risk.

  Commercial underwriters track frequency and severity of claims and often times will aid in the design & creation of the insurance policy.

  Commercial insurance underwriting process is done without a one on one engagement. The policy and exclusions are written and presented to your risk manager <u>after</u> authorization to bind coverage is placed.

  In most cases, commercial policies are designed around covering a risk while limiting that risk.

How does a Risk Manager create benefits by balancing commercial and captive policies?

- The four primary ways a risk manager should look at tying the commercial and captive policies together:
  - Deductible / SIR Reimbursement: Allows for reimbursement of deductible dollars spent on a commercial policy. A huge side benefit of this is that it allows the risk manager to increase their deductible limits and *thus reduce their commercial premium dollars.* Should the risk manager wish to they can then file a claim for reimbursement of those deductible dollars through their captive.
  - Difference in Conditions (DIC): A policy that provides expanded coverage for some perils that are not covered by standard insurance policies. Remember those exclusions in the commercial policies; this is an opportunity to revisit those and place coverage.

How does a Risk Manager create benefits by balancing commercial and captive policies?

- Wrap around policy: A risk financing program in which two or more different risk financing approaches are combined into one overall program. This is a great way to increase your coverage limits. Example:
    - Commercial GL has a limit of $1M per occurrence and a $5M aggregate limit. If you wanted additional coverage you would either have to purchase a commercial excess / umbrella policy or place another $1M layer of GL coverage through a wrap around policy in a Captive.
- Stand-Alone Policy: A stand-alone policy is one that provides coverage according to its own terms and conditions. It is to be differentiated from a follow form policy, which provides coverage according to the terms and conditions of an underlying policy.

Other areas that our Small Captive brought enhancements

Captive:

- Captive- you get to select and drive with your legal counsel.
- Captive- you get to determine what claims get submitted and thus have greater control over your loss ratio's.
- No premium audits
- Broaden scope of coverages
- Access to underwriters / reinsurers.   You can tell them your story.
- You have far greater control over your claims
- You have the ability to recapture your underwriting profits
- With in a captive the Risk Manager often times sees greater senior level management involvement
- You have greater flexibility in responding to market changes regarding your retention and risk transfer strategies

Risk Management Yesterday, Today & Tomorrow

- Yesterday- In the early 1990's risk management was about buying insurance to cover a risk exposure
- Today- Risk management has grown into something that now has elements embedded into all of our operations
- Tomorrow- As we grow and change so do our exposures and thus so does the need for a balanced risk management approach that can:
    - Provide quantitative analysis
    - Enhance your risk perception
    - Aid in addressing the human factors
    - Provide business specifics needs

Best Practices for Small Captives

Satisfy definition of insurance:

- Risk shifting
- Risk distribution
- Insurance risk
- Risk meets “commonly accepted notions of insurance”

If one makes the section 831(b) tax election:

- Maximum premium of $2.2M effective 1/1/17; $1.2M before that
  - Indexed for inflation - $2.3 M in 2018
- Meet either of the following restrictions
  - Test 1 – no more than 20% of NWP attributable to any one policyholder
  - Test 2 – no spousal or lineal descendent can own more of the insurance company than the company or asset it is insuring (with a 2% de mininmus tolerance, subject to IRS change)

Best Practices for Small Captives

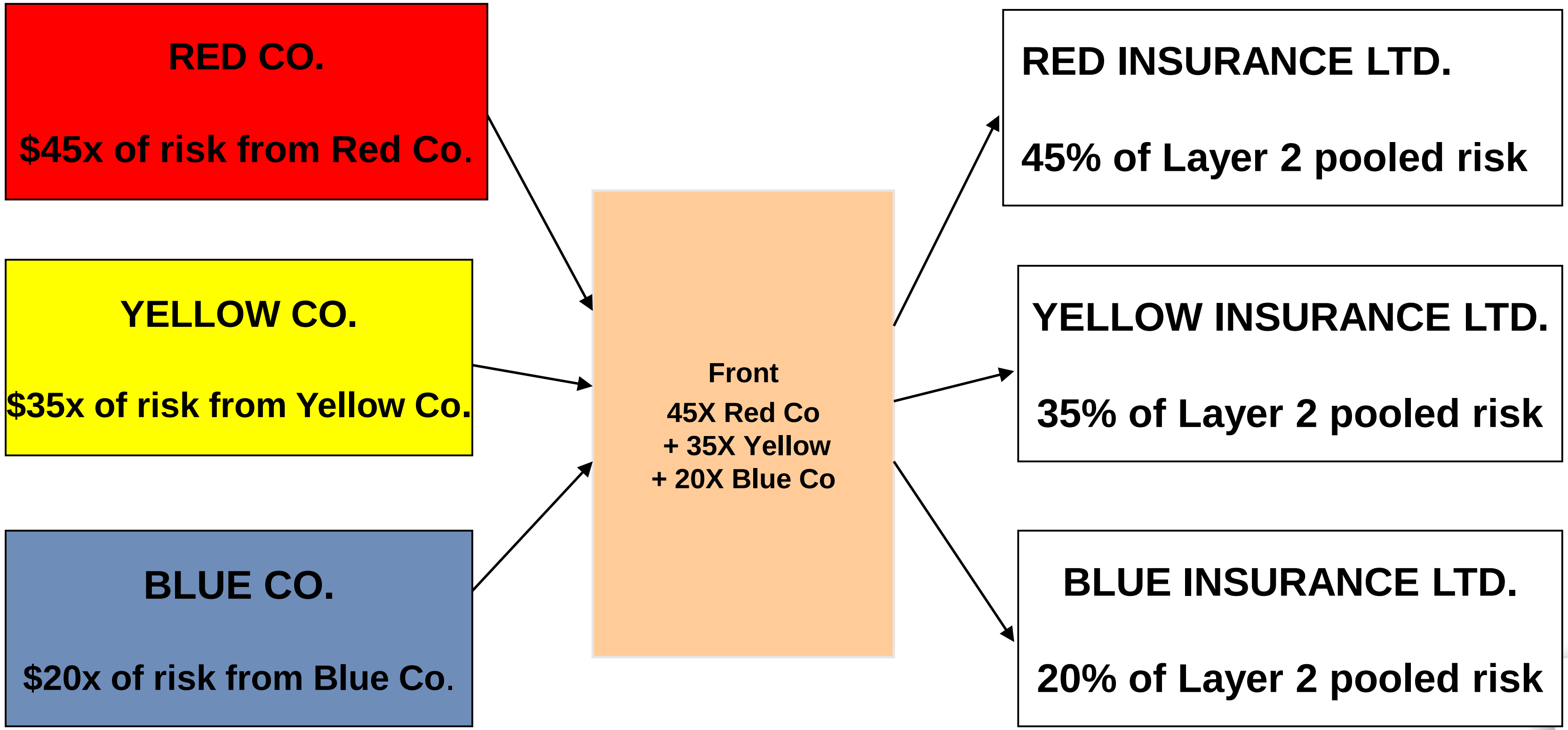
Successful captive program attributes:

- Good non-tax business purpose
- Properly funded relative to risk profile – not too high or too low
- Focus on loss control and claims management
- Fronting and reinsurance support, as necessary
- Financially stable parent(s)
- Strong business partners
- Long-term commitment from management
- Positive financial return to corporate family
- Continuous re-evaluation of business purpose and growth opportunities

Risk Pooling

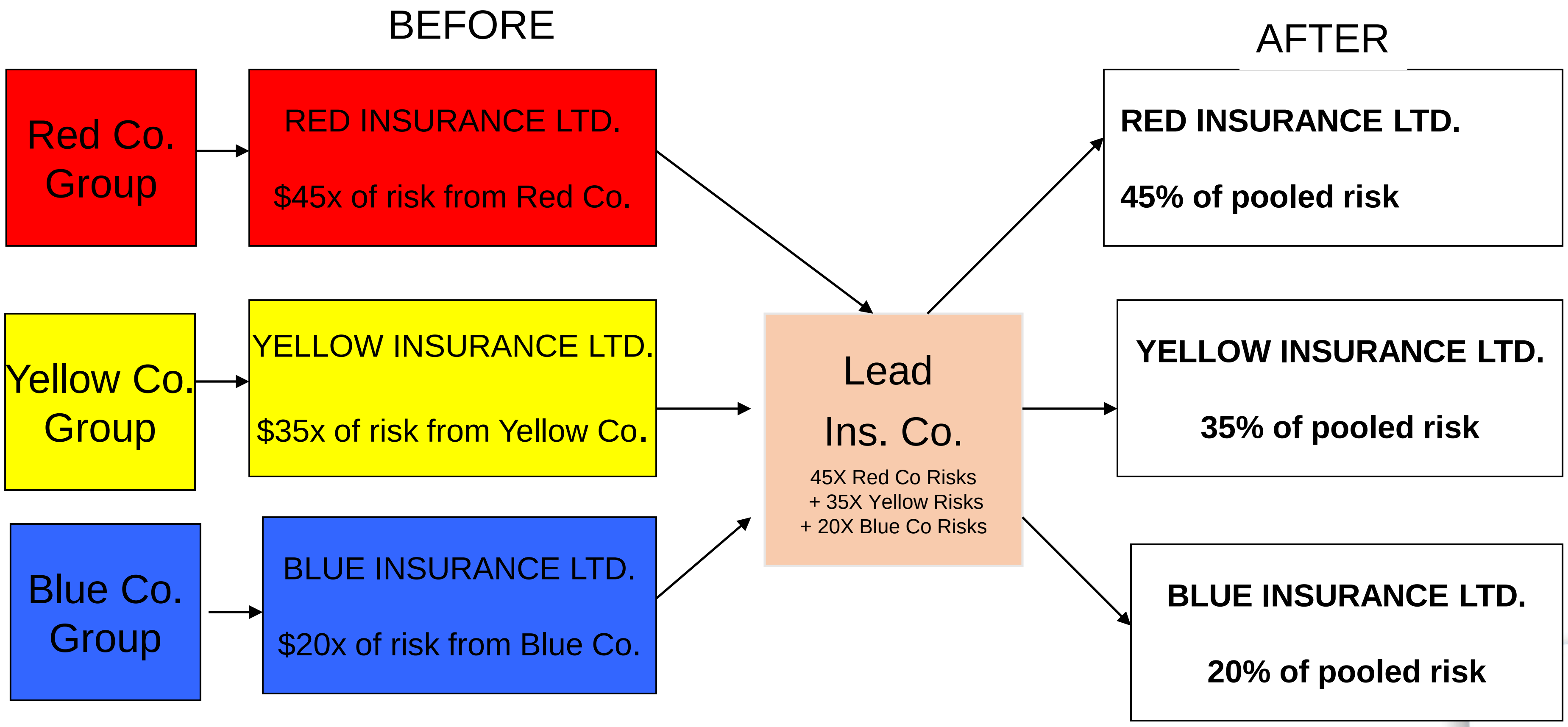
- Risk pooling refers to the spreading of insurance risks among a large group of unrelated parties in an insurance program.
- Risk pooling allows for diversification of insurance risks by spreading individual risk among the other unrelated parties.
- Differences in pool members are addressed when setting up the risk pool.
- Argument of homogeneity vs. heterogeneity of loss exposures to produce risk distribution.
    - Homogeneity, or similar, risks produce risk distribution (IRS viewpoint?).
    - Heterogeneity, or diverse, risks can produce risk distribution.

PLRs 200950016 and 200950017 (modified)



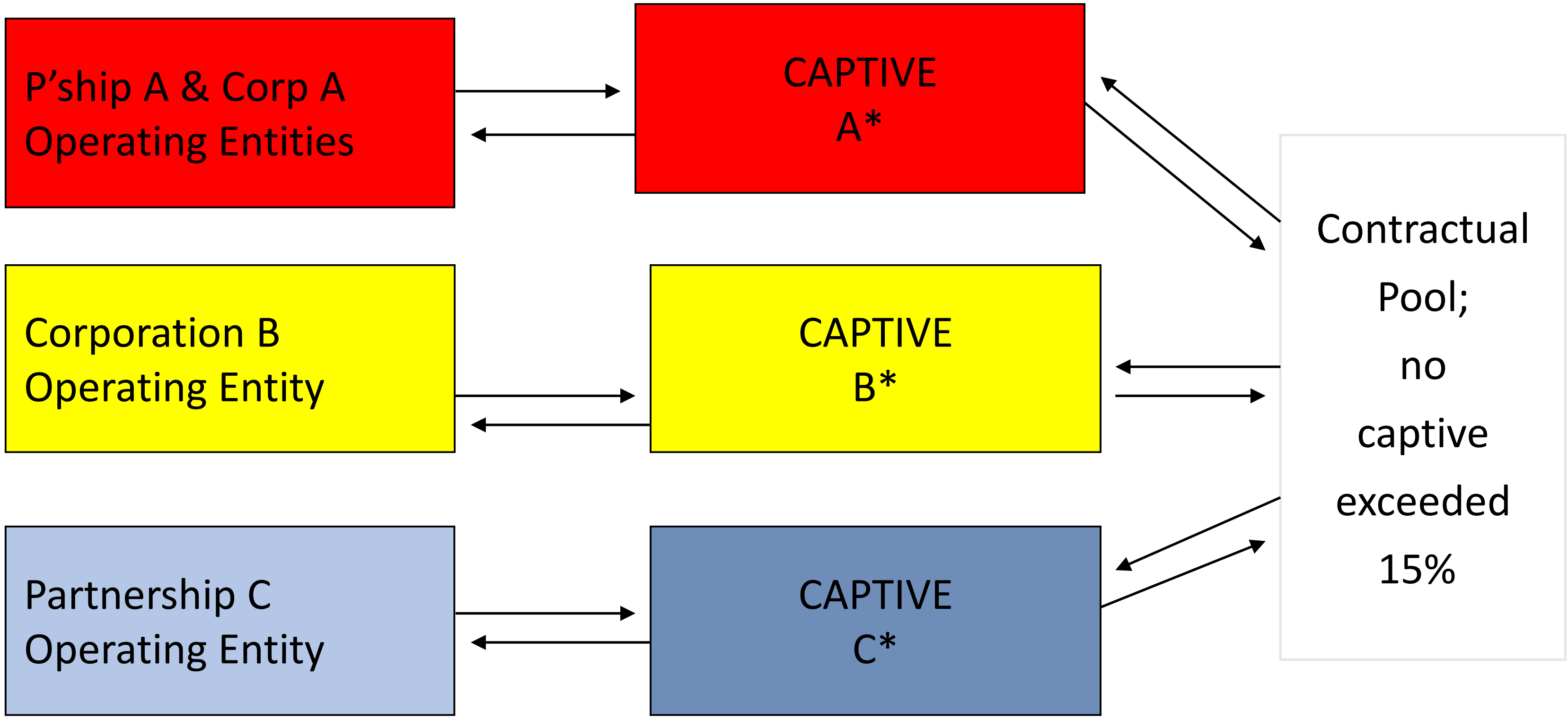
This slide illustrates pooling, but does not address the number of insureds or insurers needed for sufficient risk distribution.

PLR 200907006 (modified)



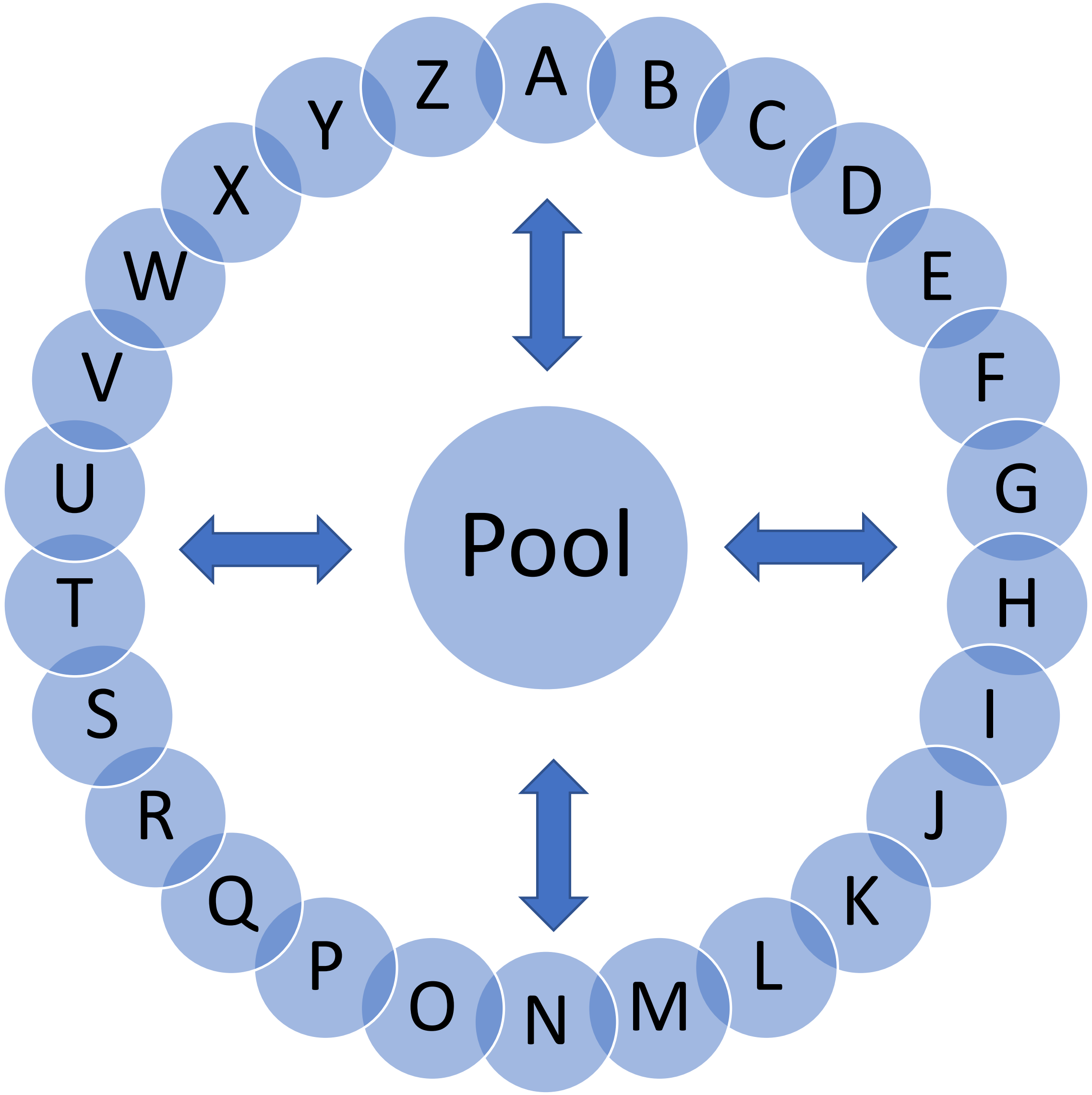
This slide illustrates pooling, but does not address the number of insureds or insurers needed for sufficient risk distribution.

PLRs 201219009-201219011 (modified)

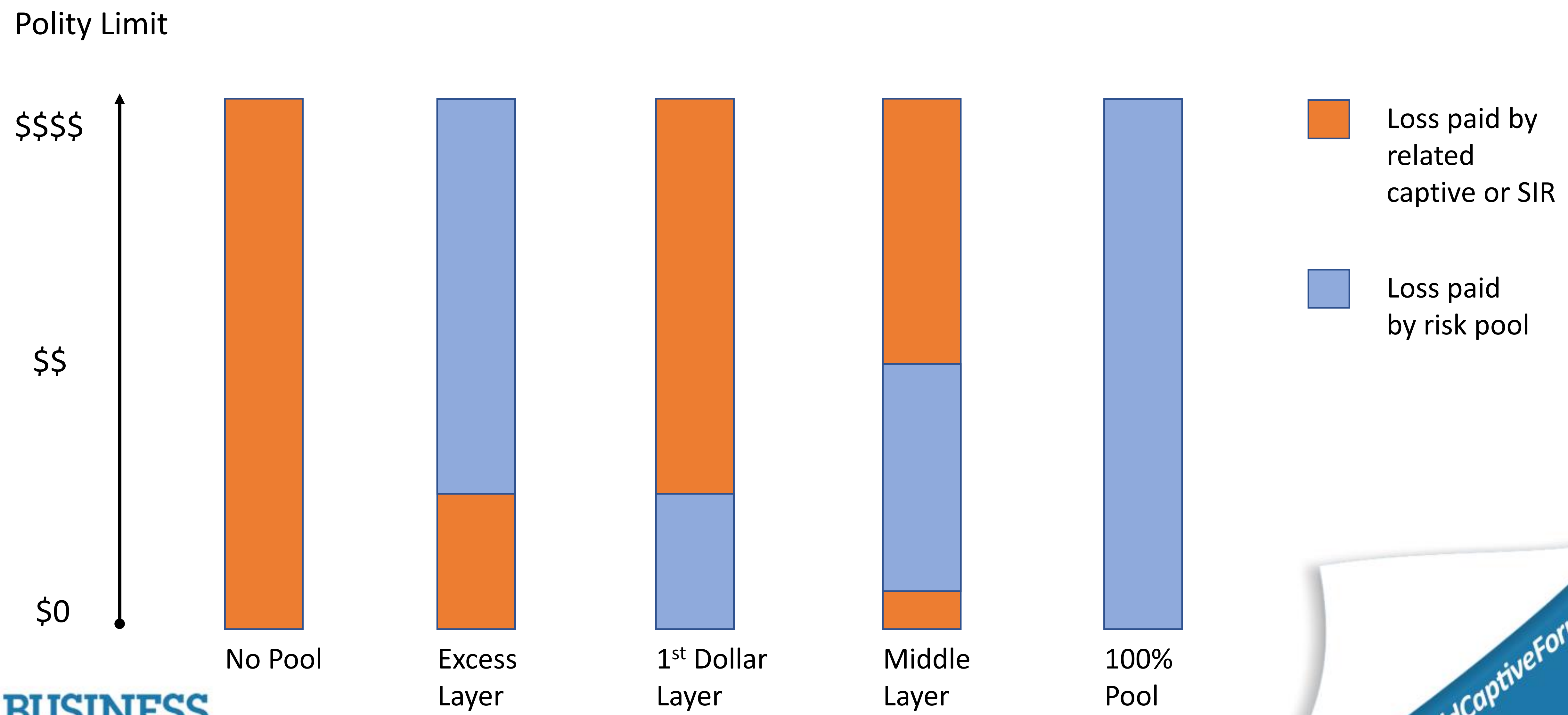


This slide illustrates pooling, but does not address the number of insureds or show the number of insurers (15) resulting in risk distribution.

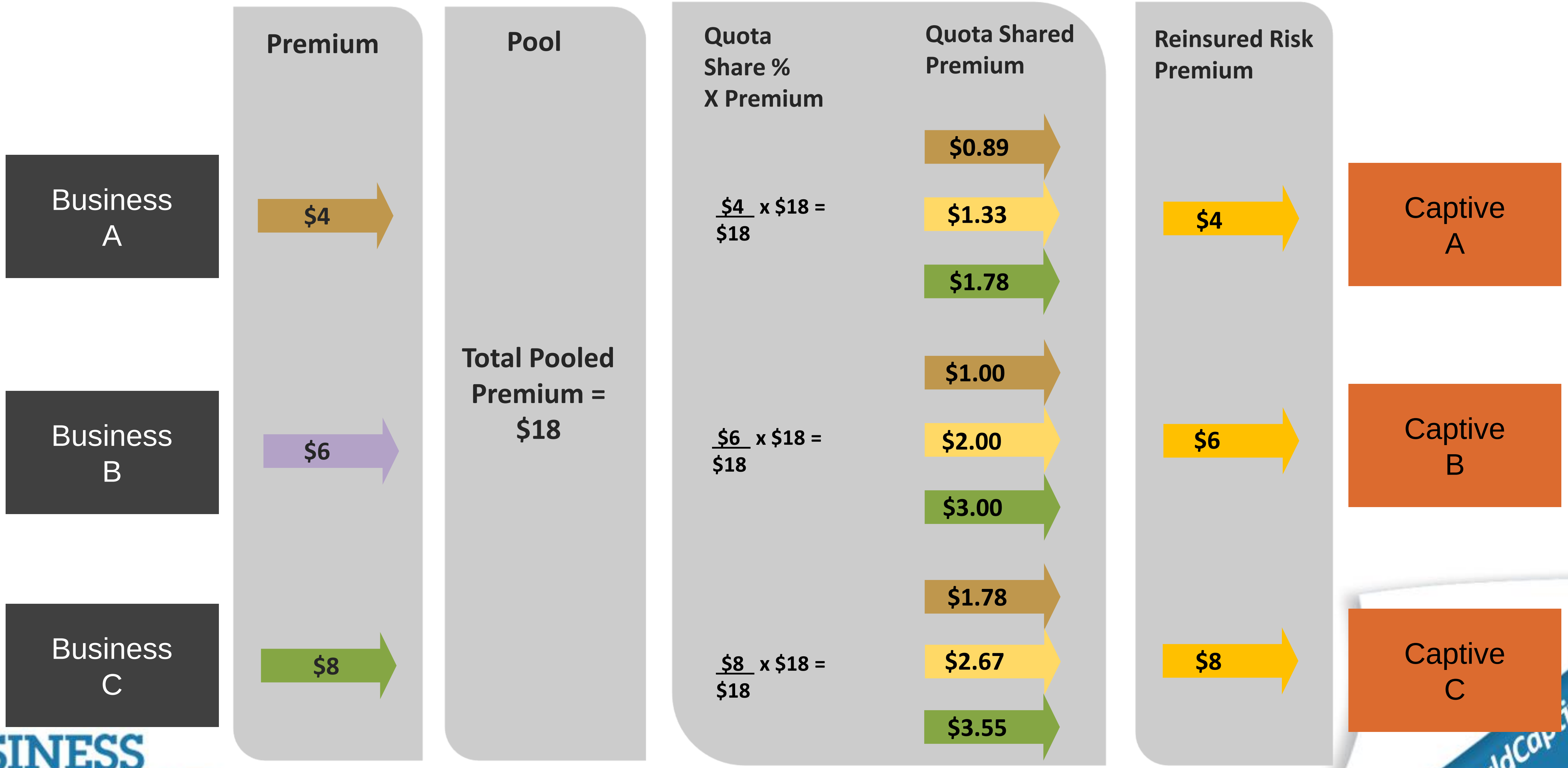
How many insureds are needed to form a pool for small captives



Risk Sharing Layer Approaches



Various approaches to sharing risk within the specified layer. For example, quota share:



Various Kinds of Risks that are Pooled

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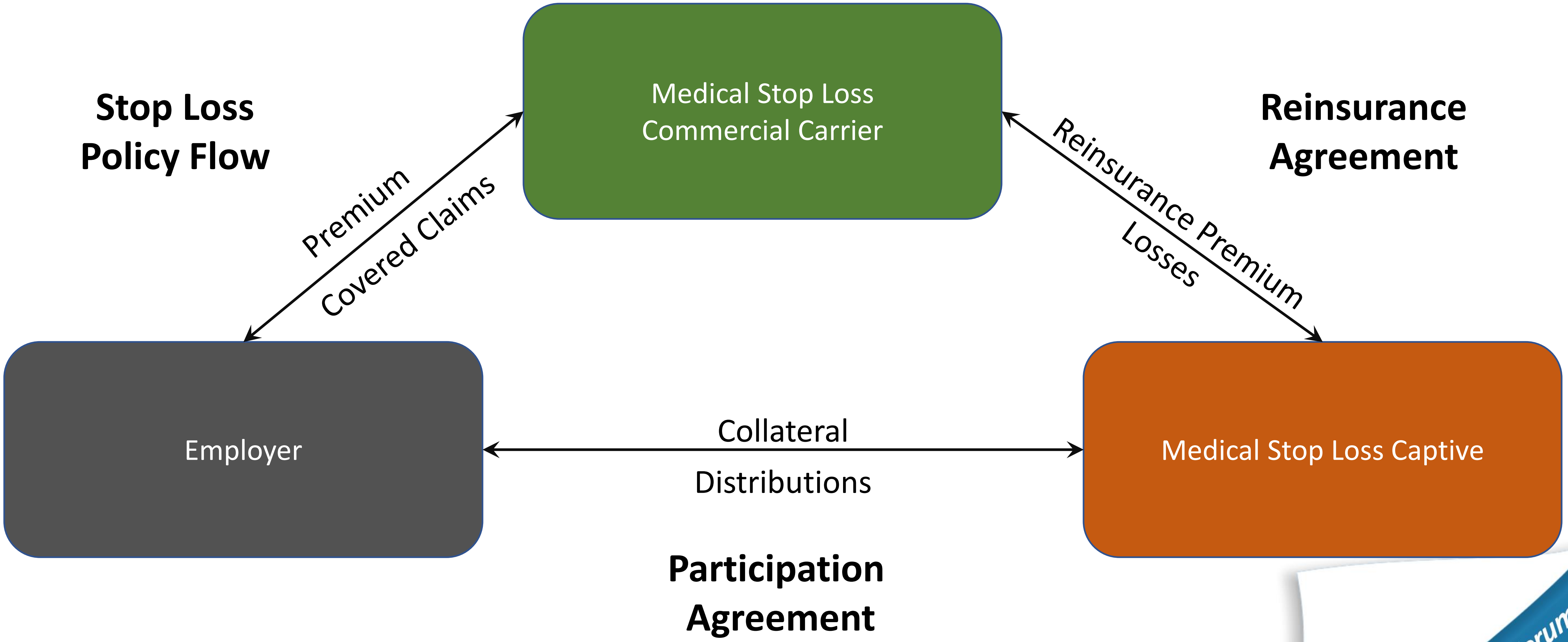
Some pools utilize commercial fronting carriers



Characteristics of a good risk pool

- Real risk is transferred
- Participants understand their proportionate share of risk
- Premium pricing has an actuarial and underwriting basis
- Has a method for reviewing and approving claims
- Has a method for securing payment of those claims

Risk Pool Deficiencies Mentioned in *Avrahami*

- Excessive policy premiums
- Ultralow probability of a claim ever being filed or paid
- Owner said he would be “shocked” if there was a claim in the risk pool
- Pool did not retain sufficient dollars to cover one single max claim
- Pool fee was flat fee instead of percentage

Avrahami Case – Actuarial Perspective

Non-standard coverages

Pricing model

Actuarial assumptions

- Support
- Consistency
- Documentation

Independent advisor

Actuarial Considerations

Pricing for clients with low or no losses:

- Review publicly available sources
- Review data from similar clients / competitors
- Review details of coverage
- Consider frequency and severity of coverage
- Consider expenses
- Discuss coverage with client
- Perform tests of reasonableness

Other concerns in the industry

- Mature risk pools insuring areas where claims are expected, but zero claims are being filed or paid
- The amount of risk exposure from others in the pool is capped at some small amount (e.g., your captive will have no more than 5% of its assets at risk for claims by others in pool)
- Retro adjustments when claims are filed such that only the client is paying on a claim and no part is risk shared with others.

Q & A

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